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S. Hrg. 103–390

U.S. COMPETITIVENESS IN THE GLOBAL MARKETPLACE

Y 4. C 73/7: S. HRG. 103-390

U.S. Competitiveness in the Global...

HEARING

BEFORE THE

SUBCOMMITTEE ON FOREIGN COMMERCE AND TOURISM

OF THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

MAY 18, 1993

Printed for the use of the Committee on Commerce, Science, and Transportation

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U.S. COMPETITIVENESS IN THE GLOBAL MARKETPLACE

TUESDAY, MAY 18, 1993

U.S. SENATE,
SUBCOMMITTEE ON FOREIGN COMMERCE AND TOURISM,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:35 a.m., in room SR–253 of the Russell Senate Office Building, Hon. John F. Kerry (chairman of the subcommittee) presiding.

Staff members assigned to this hearing: Ivan A. Schlager, staff counsel, and Troy Cribb, professional staff member; and Kevin M. Dempsey, minority staff counsel.

OPENING STATEMENT OF SENATOR KERRY

Senator KERRY. The subcommittee of the Commerce Committee will come to order.

We have an interesting morning planned and an opportunity to really get an overview, to do something that we do not always do here in the Senate in hearings; but to try to lay a record which explores an issue in some depth.

And I am particularly grateful to the chairman of the committee, Senator Hollings, for supporting the subcommittee's efforts and this committee's efforts to proceed in this area.

We have with us this morning the distinguished former Chairman of the Federal Reserve, the Honorable Paul Volcker, on our first panel. And I apologize to other panels, but his schedule is such that we need to listen to the chairman's comments and have a round of questioning and then get him back to New York, because he is off on a foreign excursion and we do need to keep the schedule there.

The second panel consists of Dr. Lester Thurow who has testified before before this committee, and Mr. Clyde Prestowitz, the president of the Economic Strategy Institute. And then a third panel, Mr. William Spriggs of the Economic Policy Institute and Mr. Robert Houseman of the Center for International Environmental Law.

Let me just say a few words as an opening statement in laymen's terms and then turn to the chairman if I may and then to my ranking member, Senator Gregg.

The playing field of trade and the economic global marketplace has obviously changed and we hear a lot of rhetoric about it. And for the last few years, we have been dabbling with strategies and really trying to understand what is happening to us.

We are currently looking at the implications of NAFTA. We have not been able to complete the last round of GATT. And all you have to do is look at the books that begin to cross our desks to understand it.

Last week I received "Prospering in a Global Economy, Mastering the New Role." I already have "Work of Nations, Preparing Ourselves for the 21st Century Capitalism," "The Silent War," "Inside Global News," "Battles Shaping American's Future," and obviously "Head to Head," "Trading Places," and "Changing Fortunes," the work product of each of our first three panelists this morning.

You cannot read these books or pick up an article dealing with trade without recognizing the extraordinary transition that is taking place.

And in many ways, it seems to me we are on a road to a confrontation that we have not completely understood and certainly not reconciled ourselves with in this country.

We have expectations that others are going to play by a basically Anglo-Saxon, Western notion of capitalism and how the rules for that game work, while the capitalism is being pursued by many of our most significant competitors does not bear resemblance to that Anglo-Saxon expectation.

Some say the Bretton Woods process has fallen apart. I would say that it was imminently successful, but that it is now outdated. In fact, it may have been successful beyond our wildest expectations, because it did permit these other countries to develop in the way that they did.

But now, clearly, we need to reexamine the rules. And each of our panelists has suggested different ways in which we might do that. But we need to do it, it is clear.

The G7 has lost its capacity to react, except perhaps in times of crisis. The last several meetings of each have been less productive than the prior one, leaving people questioning whether that act can get together sufficiently to be able to create the new rules that we need to play by.

It is also clear that the median incomes of Americans are dropping. The real wages of Americans are dropping. There are more young people in America between the 18 and 34 who are now working at low-wage jobs. And anybody looking at the playing field has to ask themselves why with business facing all of the requirements that we impose in this country—from liability to workmen's comp to environmental requirements right through the line of zoning and so forth—why there is not going to be, obviously, an even greater flow of jobs to those places where production can be engaged in at such a lower cost and less hassle, but still remains viable in the larger global marketplace.

These trends are obviously disturbing. And what is equally disturbing is the dialog in the Senate and in the House, and the political dialog of this country tends to break up into "It is either free trade or it is protectionism. But there is not a lot in between."

The problem is there is a lot in between. An examination of the approach of other countries cannot help but leave you drawing the conclusion that there is a lot in between. And we need to understand it and we need to begin to think about how we are going to

establish a set of rules by which nations can engage in this process we call trade and can begin to work out a new set of agreements.

There are many new ingredients of that process. For instance—and this is one reason why we have an environmental panelist—obviously the NAFTA side agreements and negotiations on the environment and other implications of environment are serious with respect to these rules.

If one country's environmental laws can be considered to be a nontariff trade barrier or the lack therefor can considered to be a subsidy, you clearly have a need to work out an understanding with respect to those efforts and particularly as the demands of environmental clean up and resource allocation and management become even greater as we go down the road.

So, these are enormous issues. And what is very clear to me as one Senator—and I think the chairman shares this—is that we are playing in a sort of vacuum. To a certain degree, we are playing with a lack of understanding, although there are many individual things we do understand.

We certainly understand what happened to the semiconductors. We certainly understand what happened to steel. We certainly understand what has happened to automobiles. We certainly understand what has happened to other sectors of our economy where we have not paid attention to this difference between how we perceive the behavior standard within the marketplace and how other people not only perceive it, but are acting it out.

So, today we really want to turn to some experts to try to understand better who is doing what to whom, what is the impact of what we do to each other and what courses of action we can take in an effort to try to establish some better rules by which we can all engage in solid enterprise without resorting to trade wars or without seeing the system intractably break down.

And that is our task today. And I am delighted that we have such expertise to share some thoughts with us regarding it.

Mr. Chairman.

The CHAIRMAN. Well, let me commend Chairman Kerry on taking on this initiative and giving leadership in the field of foreign commerce. I have a prepared statement and I will ask that it be included in the record. And in the light of Chairman Volcker's pressure of time here, I look forward to hearing him.

And we do appreciate him, and Lester Thurow and Clyde Prestowitz. You have got a distinguished panel. And I would like to hear them as much as we can.

Thank you.

[The prepared statement of Senator Hollings follows:]

PREPARED STATEMENT OF SENATOR HOLLINGS

Today the committee is holding another in its series of important hearings on U.S. competitiveness. One-half century ago, in the wake of World War II, America committed itself to rebuilding Western Europe, Japan, and to leading the Western alliance. This commitment was a fundamental departure from America's isolationist past, but it reaped huge rewards. Today, in the wake of the U.S. triumph in the cold war, we must devote the same degree of commitment and sacrifice to rebuilding our own economy.

First, we must face up to the fact that our decade-long daydream of free-lunch budgets has sapped the Nation's economic strength. We also must rethink U.S. trade policy. Over the last decade, the one word that can properly characterize U.S.

trade policy is "appeasement"—to maintain cold war alliances, U.S. trade negotiators were forced to make concessions that allowed others to enjoy unfettered access to U.S. markets, without allowing reciprocal access for American trade abroad. We must reverse this trend.

This town is abuzz with talk about U.S. exports and job creation. Two points must be made: (1) to be an export superpower, the United States is going to have to be competitive in its own market, and (2) what the United States exports is important. Protection of the U.S. jobs base should be our focus. Although we all want to expand trade, it should not come at the expense of the American workforce, which has suffered a steady decline in real wages for two decades.

To arrest this decline in real income, to rebuild the middle class, will require a fundamentally different approach to trade policy, one not wedded to economic theories based on the past. We must recognize that, around the world, governments have actively created comparative advantage, be it with Europe's Airbus, Korea's steel industry, or the Japanese Ministry of Finance's intervention in the Japanese stock market.

The U.S. trade policy must adapt to the fundamental changes that have taken place in the international economy. We must recognize that government should play a central role in rebuilding the strength of the U.S. manufacturing base. Government must lift the burden of debt that saps our ability to compete. Government must be committed to a technology policy that turns scientific breakthroughs into commercial triumphs. And, finally, government must be committed to a trade policy that aggressively protects American commercial interests. To that end, I look forward to working with my colleague Senator Kerry and others. I welcome our distinguished group of witnesses to the hearing today.

Senator KERRY. Senator Gregg.

OPENING STATEMENT OF SENATOR GREGG

Senator GREGG. Well, I want to thank the chairman for holding these hearings. I think they will be most informative.

There are a lot of different issues that play on the issues of trade. And I do not think we can narrow it down to one item being the cause of the U.S. problems, to the extent those problems affect various industries.

But clearly one area that I would be interested in is the whole issue of capital formation and savings in this country and to what extent the panels feel that our present tax policy or Federal policies are affecting our competitiveness internationally in those two areas.

Thank you.

Senator KERRY. Thank you, Senator Gregg.

Mr. Chairman, thank you very much for being with us and we welcome your opening statement.

STATEMENT OF HON. PAUL VOLCKER, CHAIRMAN, J.D. WOLFENSOHN & CO.

Mr. VOLCKER. Well, thank you, Senator Kerry and other Senators. I appreciate your indulgence in permitting me to go ahead here and starting a little early.

I do not get the chance to come down here so often any more. You have given us a very difficult issue to talk about. You talk about the change, Senator Kerry, in the world and how we adapt. I do not think anybody has all the answers to that.

We are in a change of transition in many respects. Perhaps you will find me still an old-fashioned, relatively liberal trader, but that is the way it is. And some of those old Anglo-Saxon rules still will work reasonably effectively.

Let me say, first of all, and emphasize the point I have in my written statement, that the economic performance of almost all the

economically advanced nations around the world has been quite unsatisfactory for some time.

On both the continent of Europe and in Japan, economic conditions are as sluggish as at any time in my personal memory. We have some expansionary forces at work, presumably, in the UK and Canada and Australia, but that follows long recessions. And the recovery even there seems rather weak and uneven.

Perhaps the United States has the clearest prospects for sustaining growth. That is not saying much in the league in which we are operating. The growth of the United States has not been fast enough to reduce unemployment by much and I expect that will remain true for some time.

Now one of the factors accounting for expectations of only modest growth in the United States is, in fact, the difficulty of expanding exports when there is so much sluggishness abroad. And the converse is true as well. Our trading partners will not be able to look to the United States to be a powerful engine for growth under current conditions and the current outlook.

And I think there is more than a negligible risk that relatively weak performance in one major area of the world will damp down already restrained performance in other areas. And the result of that is to leave the economies in transition in much of the developing world particularly vulnerable.

There are some areas, most particularly in Southeast Asia where really vigorous expansion is in progress. But those countries are not important enough economically yet to propel world business forward.

Instead the danger is that the sluggishness of the industrialized world will undercut prospects of sustaining growth in parts of the developing world. I am particularly concerned about Latin America, where conditions are already less favorable than a year or two ago.

And there may be a tendency to close markets in the West for countries in Central and Eastern Europe, countries that are struggling to open their own markets and to establish more democratic political systems. I am afraid we already see that tendency at work in specific instances.

For a variety of reasons, none of that seems to me susceptible to a quick cure. The fashionable imagery for a jump start for the American or the world economy seems to me entirely misplaced. The difficulties are infinitely more complex, varied, and deep-seated than the analogy of a dead battery, easily replaced or recharged, can begin to suggest.

The more apt comparison would be the combination of time, medicine, and strong will required to rebuild strength and full vigor after a debilitating illness.

Fortunately, I believe that here in the United States, our process of recuperation, slow as it may seem to be, is in fact proceeding about as fast as could be anticipated, given the excesses of earlier years in the debt overhang. And particularly, the returning strength of the American banking and financial system after the debacle of the 1980's seems to me really remarkable, suggesting that concern about a self-induced credit crunch may soon recede.

At the same time, prospects for much greater price stability in the years ahead seem to be more generally accepted, helping to reduce interest rates to the lowest level seen for many years.

While speculative overbuilding and a sense of ample industrial capacity will continue to restrain important areas of investment, strong competition, pressures for greater efficiency, and the rapidity of technological change are all spurring modernization efforts.

There are, I think, clear signs of significant productivity gains in a stronger international competitive position for the United States. In my opinion, all of these factors are much more important to the future of the American economy and exports than any possibility of government-directed industrial or technology policies or managed trade.

Plainly, we still have a huge problem. A lot more national savings will be needed to support high levels of investment and a stronger trade position. And they are both necessary ingredients of a dynamic growing economy.

In that light, it strikes me as both highly important and promising that the idea is finally taking hold that we must, as a matter of first priority, deal with our chronic budget deficit. The hard fact is that no other approach is available to increase the amount of net savings the Nation requires to support our own aspirations.

Fortunately, our new President has articulated that point with great effectiveness. At this stage, Mr. Clinton's program is of course more prospect than practice. As the next step, it is up to the Congress to enact the basic elements in the weeks ahead.

In urging that course upon you, however, I must add that the measures that the President has proposed thus far can, in my judgment, only be a first step toward achieving balance in the Federal budget.

I realize the medium term "budgetary outlook" is always uncertain and will be affected by the new proposals for national health care the President will shortly set down. But all my experience and my judgment suggests that much stronger measures will need to be taken if an approach to budgetary balance is to be achieved in this century.

And those measures will need to include restraining growth in entitlement programs. All of that is directly relevant to the trade deficits that seem so troublesome today.

As a country with an exceptionally high rate of consumption, with a chronically low savings rate and with a budget deficit that absorbs one-half or so of those savings, we will necessarily have an unsatisfactorily low rate of investment or borrow huge amounts of capital from abroad or do both.

That is essentially a description of the situation of the United States and it has been for a decade. It is fundamental to an explanation of why our trade deficit seems so intractable, even in the face of sizable depreciation of the dollar, new restraints in some of our most important imports and visible progress toward opening markets for some of our principal trading partners.

Unless we come to grips with the basic fact that as a nation we save too little and consume too much, depreciation of the dollar could only make us poorer and weaker. More rapid opening of other markets, important and constructive as that would be, will not cure

our trading deficits. And to resort in frustration to closing our markets would be in the end to undercut the open trading order that has supported the growth and prosperity of the Western world.

Now I recognize the American market is certainly among the most open in all the world. That is still true despite the number of nontariff barriers imposed in the past decade or more, barriers that by some estimates cover as much as one-third of all imports.

We are all familiar with policies and actions of others that hinder and displace our exports in areas where we have had a strong comparative advantage, including agriculture, aerospace, and high-technology sectors. Even where most official barriers to our exports have been eliminated or greatly reduced, as in the case of Japan, old customs and ingrained cultural patterns may effectively block imports of our manufactured goods.

Resistance to direct investment by American and other foreign companies and Japanese enterprises may itself reduce our export opportunities. We plainly have a strong and legitimate economic interest in seeing barriers to our exports reduced and curtailing trade and other subsidies distorting trade and in resisting flagrant dumping.

Moreover, as a practical matter, political support in this country for an open multilateral trading system rests on a perception of progress in dealing with these areas. The only real question can be how best to proceed in seeking those goals, recognizing that in the end the interests of the United States coincide with those of our trading partners in an open, harmonious trading order.

I realize there is no simple or easy answer to that question. In particular, I realize that the present administration, like its recent predecessors, finds it necessary from time to time to threaten restrictions on access to our markets in the absence of reasonable progress toward access by U.S. companies to foreign markets.

Inevitably, too, progress in one set of international negotiations will have a bearing on the possibility of agreement on other areas. But it is equally true that without some guiding principles, agreed objectives and recognition of the realities of the present situation, a succession of ad hoc pragmatic approaches will do grave damage to prospects for an open trading system.

In that spirit, I will conclude with a few broad observations. First, given the unsatisfactory world economic situation, the political temptation to resort to unilateral restraints on trade in many countries is strong. Correspondingly, the risks of tit-for-tat retaliation are larger than in the past.

Second, failure to find a satisfactory conclusion to the long-awaited GATT round this year would add greatly to the danger. One obvious result would be to delay the potential gains from further liberalization of trade. But that to me is the least of the problem.

More important, given the immediate circumstances, would be the psychological and symbolic reinforcement in the United States and elsewhere of thoughts to resort to unilateral action, skirting or even ignoring GATT rules and disciplines on the basis that that organization is impotent and discredited.

Then we would face the clear and present danger of undercutting the recovery and future growth of the world economy.

Third, no doubt important and difficult issues on the international agenda are assuming greater urgency. The areas of environmental protection, arms control, human rights, and the treatment of labor and investment are cases in point.

Some of those issues bear fairly directly on trade, others only tangentially. But in either case, there are practical, political, and conceptual limitations on our ability to tie progress on those issues to already complicated and contentious areas of trade negotiations.

Moreover the evidence seems to me quite clear that given time, progress toward a liberal multilateral trading order will, for fundamental reasons, ordinarily in and of itself promote progress toward an open political system with greater respect for the environment and human rights.

Fourth, that circumstance seems to me relevant to consideration of both the North American Free Trade Agreement and continuation of most-favored-nation treatment for China. In both cases, the negotiation of maintenance of trade agreements might appropriately provide the occasion for reminding our partners to the importance we attach to other areas.

In some cases, it may well be possible to reach common understandings about specific approaches of policies in related areas, particularly when our concerns parallel those of the broader world community.

But experience also suggests that efforts to attach essentially political conditions on trading agreements or to attempt to force our policy demands by unilateral trade restraints will be successful, if at all, only in rather unusual or extreme circumstances. If the result is simply to undercut open trade, the results will be counterproductive.

In essence, what I am urging in all these negotiations and in our approach to trade, is that we recognize the fundamental importance of first getting our own fiscal and economic house in order and second, the benefits to the United States of political as well as economic terms of open and nondiscriminatory trade.

We at long last have a real chance of working toward budget balance in a context of economic growth and stability. A strong GATT with clear and more effective international rules and dispute settlement procedures is in our interests, and within the collective grasp of Europe, Japan, and the United States to achieve.

We benefit today and we will in the future from open trade with Mexico and from the growth of China. And by our actions now, we can reinforce that prospect.

Pragmatism and leverage have their place in trade policy as elsewhere. But in the exercise of the pragmatism and leverage, we better not lose sight of the central objective of a liberal trading order. That is an objective the United States, as champion for one-half a century, to its benefit and to that of forces of openness in economic progress all over the world.

It seems to me the essence of hard-headed pragmatism to recognize that there is no satisfactory substitute for continued American leadership in that respect today.

Thank you.

[The prepared statement of Mr. Volcker follows:]

PREPARED STATEMENT OF PAUL VOLCKER

You have asked that I discuss with you this morning some general areas of trade policy and their relationship to the global and American economic situation. I am glad to do so. with the understanding that I can claim no special expertise in the details of many of the trade negotiations currently underway.

This opening statement is relatively brief, but I would like to make a few general points to help set the stage for our subsequent discussion.

I am sure you are well aware that the economic performance of most economically advanced nations has for some time been unsatisfactory. On both the continent of Europe and in Japan, economic conditions are as sluggish as at any time in memory. Expansionary forces after long recessions in the U.K., in Canada, and in Australia, are in varying degrees still rather weak and uneven. Perhaps the United States has clearest prospects for sustaining growth, but, as you know, that growth has not been fast enough to reduce unemployment by much, and that may remain true for some time.

One of the factors accounting for expectations of only modest growth in the United States is the difficulty of expanding exports in the face of the sluggishness abroad. Conversely, our trading partners will not be able to look to the United States to be a powerful engine for growth. Indeed there is more than a negligible risk that relatively weak performance in one major area of the world will damp down already restrained performance in other areas.

Among the most vulnerable are the economies in transition and much of the developing world. Fortunately, there are some areas, most particularly South East Asia, where really vigorous expansion is in progress. But those countries are not important enough economically to propel world business forward. Instead, the danger is that the sluggishness of the industrialized world will undercut prospects for sustaining growth in Latin America, where conditions already seem less favorable than a year or two ago, and will in practice lead to a tendency to close markets In the West for countries in Central and Eastern Europe struggling to open markets and establish more democratic political systems.

For a variety of reasons, none of that seems to me susceptible to a quick cure. The fashionable imagery of a "jump start" for the American or the world economy seems to me entirely misplaced. The difficulties are infinitely more complex, varied, and deep-seated than the analogy of a dead battery, easily replaced or recharged, can begin to suggest. The more apt comparison would be the combination of time, medicine, and strong will required to rebuild strength and full vigor after a debilitating illness.

Fortunately, I believe that here in the United States that process of recuperation, slow as it may be, is in fact proceeding about as fast as could be anticipated, given the excesses of earlier years and the debt overhang. In particular, the returning strength of the American banking and financial system after the debacle of the 1980's seems to me remarkable, suggesting that concern about a self-induced "credit crunch" may soon recede. At the same time, prospects for much greater price stability in the years ahead seem to be more generally accepted, helping to reduce interest rates to the lowest levels seen for many years. While speculative overbuilding and a sense of ample industrial capacity will continue to restrain important areas of investment, strong competition, pressures for greater efficiency, and the rapidity of technological change are all spurring modernization efforts. There are clear signs of significant productivity gains and a stronger international competitive position. In my opinion, all these factors are much more important to the future of American economy and exports than any possibilities of Government-directed industrial or technology policies or managed trade.

Plainly, we still have a huge problem: A lot more national savings will be needed to support high levels of investment and a stronger trade position—both necessary ingredients of a dynamic, growing economy.

In that light, it strikes me as both highly important and promising that the idea is taking hold that we must, as a matter of first priority, deal with our chronic budget deficit. The hard fact is that no other approach is available to increase the amount of net savings the nation requires to support our own aspirations. Fortunately, our new President has articulated that point with great effectiveness.

At this stage, Mr. Clinton's program is, of course, more prospect than practice; as the next step, it is up to Congress to enact the basic elements in the weeks ahead. In urging that course upon you, however, I must add that the measures that the President has proposed thus far can, in my judgment, only be a first step toward achieving balance in the Federal budget.

I realize that the medium term budgetary outlook is always uncertain, and will be affected by the new proposals for national health care the President will shortly

set out. But all my experience and my judgment suggests that much stronger measures will need to be taken if an approach to budgetary balance is to be achieved in this century—and those measures will need to include restrained growth in entitlement programs.

All of that is directly relevant to the trade deficits that seem so troublesome today. A country with an exceptionally high rate of consumption, with a chronically low savings rate, and with a budget deficit that absorbs half or more of those savings will necessarily have an unsatisfactorily low rate of investment or borrow huge amounts of capital from abroad, or both. That essentially is a description of the situation of the United States, and it has been for a decade. It is fundamental to an explanation of why our trade deficit has seemed so intractable even in the face of sizable depreciation of the dollar, new restraints on some of our most important imports, and visible progress toward opening markets by some of our principal trading partners.

Unless we come to grips with the basic fact that, as a nation, we save too little and consume too much, depreciation of the dollar could only make us poorer and weaker. More rapid opening of other markets, important and constructive as that would be, wouldn't cure out trading deficits. And to resort in frustration to closing our markets would, in the end, be to undercut the open trading order that has supported the growth and prosperity of the Western world.

I recognize the huge American market is among the most open in all the world. That is still true despite the number of non-tariff barriers imposed in the past decade and more—barriers that by some estimates cover as much as a third of all imports. We are all familiar with policies and actions of others that hinder and displace our exports in areas where we have had a strong comparative advantage, including agriculture, aerospace, and other "high tech" sectors. Even when most official barriers to our exports have been eliminated or greatly reduced, as in the case of Japan, old customs and ingrained cultural patterns may effectively block imports of manufactured goods. Resistance to direct investment by American and other foreign companies in Japanese enterprises may itself reduce our export opportunities.

We plainly have a strong and legitimate economic interest in seeing barriers to our exports reduced, in curtailing export and other subsidies distorting trade, and in resisting flagrant dumping. Moreover, as a practical matter, political support in this country for an open multilateral trading system rests upon a perception of progress in dealing with these areas.

The only real question can be how best to proceed in seeking those goals, recognizing that in the end the interests of the United States coincide with that of our trading partners in an open, harmonious trading order. I realize there is no simple and easy answer to that question. In particular, I realize that the present Administration, like its recent predecessors, finds it necessary from time to time to threaten restrictions on access to our markets in the absence of reasonable progress toward access by U.S. companies to foreign markets. Inevitably, too, progress in one set of international negotiations will have a bearing on the possibility of agreement in other areas. But it is equally true that without some guiding principles, agreed objectives, and recognition of the realities of the present situation that a succession of ad hoc "pragmatic" approaches will do grave damage to prospects for an open trading system.

In that spirit, I will conclude with a few broad observations:

- Given the unsatisfactory world economic situation, the political temptation to resort to unilateral restraints on trade in many countries are strong. Correspondingly, the risks of "tit-for-tat" retaliation are larger than in the past.
- Failure to find a satisfactory conclusion to the long-awaited GATT round this year would add greatly to the danger. One obvious result would be to delay the potential gains from further liberalization of trade. But that, to me, is the least of the problem. More important, given the immediate circumstances, would be the psychological and symbolic reinforcement that would be provided those in the United States and elsewhere prepared to resort to unilateral action, skirting or even ignoring GATT rules and disciplines on the basis that the organization was impotent and discredited. Then we would face the clear and present danger of undercutting the recovery and future growth of the world economy.
- No doubt important and difficult issues on the international agenda are assuming greater urgency. The areas of environmental protection, arms control, human rights and the treatment of labor and investment are cases in point. Some of these issues bear fairly directly on trade; others only tangentially. But in either case, there are practical, political, and conceptual limitations on our ability to tie progress on those issues to already complicated and contentious areas of trade negotiations. Moreover, the evidence seems to me quite clear that, given time, progress toward a liberal multilateral trading order will, for fundamental reasons, ordinarily in and

of itself promote progress toward an open political system, with greater respect for the environment and human rights.

• That circumstance seems to me relevant to consideration of both the North American Free Trade Agreement and continuation of Most Favored Nation treatment for China. In both cases, the negotiation or maintenance of trade agreements might appropriately provide an occasion for reminding our partners of the importance we attach to other areas. In some cases, it may well be possible to reach common understandings about specific approaches or policies in related areas, particularly when our concerns parallel those of the broader world community. But experience also suggests efforts to attach essentially political conditions on trading agreements or to attempt to enforce our policy demands by unilateral trade restraints will be successful, if at all, only in rather unusual or extreme circumstances. And, if the result is simply to undercut open trade, the results will be counter-productive.

In essence, what I am urging is that in all these negotiations, and in our approach to trade, we recognize the fundamental importance of, first, getting our own fiscal and economic house in order and, second, the benefits to the United States—in political as well as economic terms—of open and non-discriminatory trade.

• We, at long last, have a real chance of working toward budget balance in a context of economic growth and stability.

• A strong GATT, with clearer and more effective international rules and dispute settlement procedures is in our interest, and within the collective grasp of Europe, Japan and the United States to achieve.

• We benefit today, and we will in the future, from open trade with Mexico, and from the growth of China—and by our actions we can reinforce that prospect.

Pragmatism and leverage have their place, in trade policy as elsewhere. But in the exercise of that pragmatism and leverage, we had better not lose sight of the central objective of a liberal trading order. That is an objective the United States has championed for half a century, to its benefit and that of the forces of openness and economic progress all over the world. It seems to me the essence of hard headed pragmatism to recognize there is no satisfactory substitute for American leadership today.

Senator KERRY. Thank you very much, Mr. Chairman.

Senator Rockefeller has joined us.

I will turn to the chairman first.

The CHAIRMAN. Chairman Volcker, right to the point, if I were king or President, I would have you as my chairman once again. I want to emphasize my respect. I will never forget you saved the country in the early eighties, although you have been summoned up here to hearings as to whether or not you even ought to be appointed.

So, you and I have been working this budget field for a long time, getting our own fiscal and economic house in order, yet the best of the best; namely you, will not say the word "tax." I have watched you fellows, Greenspan, every one of you, you all tippy toe around.

Now, let me get to the entitlements. You take on that virus that is running through the Congress. There is a tremendous surplus in the Social Security. That is the biggest of all entitlements. In fact, by the year 1999—we got the figure the other day—we will owe Social Security a trillion bucks. There is a surplus with respect to the Civil Service retirement. Yes, with respect to the Medicare/Medicaid entitlements, we all recognize their growth, and to President Clinton's credit, he put the First Lady in charge. We have got the country's attention, and we are going to make the first real assault on that particular issue. We all can agree on that.

But, having agreed upon it, the health situation is going to bring in some 35 million additional patients to be covered, and that is going to take money. So, there is not going to be any saving there. And as we have said, and we could have said this for the last 10 years just about, we could eliminate the domestic Government and still have a deficit. Eliminate not cut.

Rather, do away with the domestic Government, the President, the Congress, the courts, the FBI, the food stamp program, the welfare program, the foreign aid program—just do away with it all—and you still have over a $150 billion deficit.

I could see this, because you were coaching me and others back in the mid-eighties. I testified for a value added tax to try to get us into the black when we had gotten the deficit down from $221 billion to $150 billion—and I was trying to get it down below $100 billion before we started the monkeyshines of smoke and mirrors and telling everybody about summit agreements and that we were reducing the deficit through $500 billion in savings. And of course it went on up to where it is right now at $400 billion.

We are cutting defense—and we could eliminate the domestic budget, and you still need taxes. And unless and until those in fiscal leadership such as yourself start talking about the need for revenues—we will continue with this standoff of who is for taxes and who is against taxes. It is just sheer childish nonsense that goes on up here.

And on that score, President Clinton has hit the ball somewhat, as you say in golf, but failed to follow through. In other words, he said I am going to cut the White House staff 25 percent, eliminate 100,000 jobs, freeze his pay, my pay, everybody else's pay, put the Vice President in charge of auditing the Departments, and Ms. Clinton herself in charge of health costs. He tripped up with not paying the bill on the stimulus package, and we are now back into the standoff of tax and spend, spend and tax, like there is some choice.

Do you see any choice? I realize we have got to have cuts. I led the fight for a freeze with you for 5 or 6 years, just to freeze the spending. And we are going to freeze pay if we can. I see it breaking ranks with respect to the military. I serve on that subcommittee. But can you see any way out of this other than some additional revenues; namely taxes?

Mr. VOLCKER. I have no doubt we are going to have raise taxes if we are going to deal with the budget deficit. I was not conscious that the word "tax" had not appeared in my statement. I thought in supporting what Mr. Clinton said I was very conscious that his program at this stage is mostly taxes.

The CHAIRMAN. Yes.

Mr. VOLCKER. I think the question is: At what level essentially of spending, relative to the GNP, to use that measure, can we balance the budget? And I think there is politically a lot of sense in the country that we do not want to do it entirely at the current level of spending relative to GNP or higher, and that we will need some cut in spending relative to GNP—not in absolute terms—to reach some kind of a consensus on where the budget can be balanced.

I specifically think the time has come when we have got to think about moving the tax structure, if we are going to balance the budget, toward a consumption tax. And that means either a value-added tax in my mind or a broader based consumption tax, which would be more revolutionary. I think I must point out that Mr. Clinton has made a proposal that moves in that direction with the

energy tax, which itself is a pretty broad-based tax, and is fairly controversial up here.

If I may just say one more word on the expenditure side, I would like to claim a few credentials that I did not have when I used to appear more frequently before the Congress. I am now on a civil service pension. I am 65 years old and have had a wife in the hospital for a month, so I know something about medical bills. And I do think that we are going to have to admit—as you point out, the ordinary cost of Government does not equal the deficit. We have got to look into that entitlement area if we are going to reduce the rate of spending increase relative to the growth in the economy.

Social Security is in surplus this year, and it is going to be in surplus for a decade or so ahead if you measure the surplus by current revenues against current Social Security expenditures. But if you look at it over a longer time period, as a generational affair, the Social Security system, even with the recent increases in payroll taxes, is going to go into deficit by a considerable amount. And I think that raises a relevant question, such as, given the extension of human life anyway in the last 50 years and the projections ahead, whether we should not move a little more rapidly toward increasing the retirement age both for Social Security and for Medicare. And there are similar questions that arise in other areas.

The CHAIRMAN. And I will agree with that. In fact, we recommended the early eighties, 10 years ago, to freeze Social Security and not have the COLA. And I harken back with President Johnson, with the Great Society, and we thought of every way in the world of spending money, but we did not think of a COLA for Social Security then. Wilbur Mills was the one that came to town and started really spending it.

I supported the President Clinton program in the budget committee of the millionaire's tax, the Btu tax and the Social Security tax. Even there, projected out, 4 years from now, President Clinton ends up with a deficit just as large as the one he inherited from President Bush. So, he has got to do more. That is how desperate the circumstance is.

Mr. VOLCKER. I am very conscious of it. If you go beyond that period that he has been projecting, of 1998, the projections that we have available, as weak as any projection 5 years ahead is, all pretty clearly show a renewed increase in the deficit, rather than a further reduction.

The CHAIRMAN. Very good.

Thank you, Mr. Chairman.

Senator KERRY. Thank you very much, Senator Hollings.

Mr. Chairman, as I listened to your testimony, and it is one of the reasons we wanted you to come and frame this, I could not help but agree with the fundamental precepts. We do want an open, nondiscriminatory trade regime, clearly. And we do, obviously, need to get our house in order. In addition, you recommended we have a strong GATT.

Now there is a question I want to get to about how you get there, because many argue that we cease to have the leverage to get us there, and it is not in the Europeans' interests at this moment to get us there. But, before that, there is a threshold question. You say the central objective is this liberal trading order. And as you

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closed your comments, you said I want to emphasize we have an open trading system and we are saving too little and consuming too much.

Now, as I have been studying this issue in the last months and trying to learn more about it, I am struck by the degree to which we do not have a liberal trading order, but operate ourselves as if we did. I mean the wish is sometimes father to the fact, but in this case appears not to be. And we are sitting here wishing or presuming that the best order is to have this liberal trading policy, yet others are clearly behaving differently.

Now, let me give you a quick list of some of those and ask your reaction to it.

In the color television industry, we face the loss of our indigenous color television industry through overt price fixing, market allocation, subsidization, targeting, dumping—I mean, clear unfair trade practices—and we did nothing.

In automobiles, in steel, in machine tools, in constructive engineering, we face different kinds of problems, closed markets, and subsidies. In commercial aircraft, we have faced subsidies, countries who wholly subsidize. And we are now suddenly appointing a commission to examine what might be obvious that has been happening to our commercial airline industry for some time.

Heavy electrical generating equipment: there have been no sales in Europe since the 1960's.

Semiconductors: I read Alan Wolff's "Conflict Among Nations." It seems as if the former U.S. Trade Representatives and former Deputy U.S. Trade Representatives are all now articulating very clearly the patterns with which we are faced. But in semiconductors, there is just an astonishing story of a combination of our putting our head in the sand like an ostrich and pretending something was not happening to us when it was.

In soft wood lumber, you look at the Canadian practice of the stumpage fee, so much different than ours. A clear policy of the nation to provide for jobs by undercutting the price in the United States. You can go industry for industry. And I think the American workers are reflecting that today in their frustration and anger.

So, the question I ask you is really: Notwithstanding our desire and notwithstanding within a perfect order, it is clearly better to have a liberal system. We do not have one today. How do we get there? What steps do we need to take? Or do you disagree that these imbalances exist?

Mr. VOLCKER. I do not disagree that the imbalances exist, by and large. But I think we have the proverbial half-filled glass here. You have emphasized the difficulties that remain. I think if one looks back over the preceding 10 or 15 years, the pattern is pretty clear of one of lesser restraints on the part of our major trading partners today than was the case, let us say, in the 1970's. Whereas the opposite has happened in the United States.

We have participated in this process of less than purity in trade, and we have more trading impediments now than we had 10 or 15 years ago. I think we are still, among the major countries, clearly the most open market—not just legally, but culturally, I suppose. And Japan, which to take the extreme case, has done a lot to open up legally, is still very closed culturally.

Nonetheless, the movement I think has been in the direction of more open trade and we should not give up.

Now, what has happened, it seems to me, during this period while progress was being made in opening up other markets, the U.S. external position was suffering for other reasons, other than any relative change in trading restrictions. The other reasons include our fiscal position, our propensity to consume rather than save and our relatively low investment.

The world is in a very sluggish economic situation, where what I believe—I cannot prove it—but what I believe, and I think there is a considerable amount of evidence, where the improved competitive position of the United States is not fully evident because demand is so sluggish abroad. But I do think that we are fundamentally in a better position to compete in this market, this world market, than we were in the past decade. And we can do it without increasing restraints.

Now, to take the biggest industry, in terms of our trade position, certainly with Japan, the auto industry, we have this enormous deficit which accounts for a very large proportion of this rather horrendous sounding trade deficit with Japan. My sense is that for the first time in 10 or 15 years, our industry is able to compete pretty much head to head with the Japanese industry. Maybe we will even have a little edge in that Japan, in terms of imports—not necessarily the cars produced here, but in terms of imports, is going to find it difficult to maintain its penetration of the market. That is the first time we can say that in my memory. And maybe it will get reversed.

That is all hard to see when Japan, for them, is in a rather major recession. But I do think that we are in a situation in that industry, and I think you could say in other industries, where a basic strengthening in our competitive position ought to begin showing much more clearly as the world economy recovers and expands, which is an important objective, but which is not happening at the moment. I think one can say the same thing vis-a-vis Europe, but maybe a little less dramatically.

I do think we are making progress in cutting down, however tortuous and slow the process may be, the restrictions in other countries. It is very difficult right now when you have the high unemployment and sluggishness in Europe, in particular. And the current threat is that they are putting on more restrictions, certainly vis-a-vis Eastern Europe and Central Europe.

The commercial aircraft industry is a case in point, where you have a clear policy on the part of Europe to subsidize the development of the Airbus. They sometimes claim that our industry benefited from our large defense spending. I do not know the merits of that—not as much as they say I am sure. But even there, I think we have made some progress in helping to level that playing field.

Senator KERRY. Could I interrupt you there just for a minute?

There is a clear distinction between the legitimate self-initiated spinoffs of our defense industry and, indeed, of other sectors of our economy, where we have prided ourselves in our venture capital and risk taking efforts, versus, for example, the semiconductor industry. There was an absolute targeting with government involvement. I mean whether it is Deutsche Bank or MITI, there have

been significant collusive efforts that under our law would simply be prohibited.

I mean the zaibatsu, followed by the keiretsu, is antitrust.

Mr. VOLCKER. Right.

Senator KERRY. Now, we prohibit our companies from doing what they are allowed to do under their law. And then we sit there and wonder why we are losing in the market.

Mr. VOLCKER. I have no doubt that keiretsu mentality in Japan, to take that particular example, has trade implications. And it is very much ingrained with the Japanese way of doing business. A lot of cross-ownership. One of the side effects—one of the direct effects works through the investment side where it is very difficult for a foreign firm, an American firm or another foreign firm, to acquire a Japanese company because it is not considered the thing to do in Japan, and they can enforce what they consider the thing to do by the cross-ownership. The stock is not available in the marketplace even if you wanted to become aggressive and confrontational about it.

Now, how do you deal with that? First of all, it is not absolute. I do think we are in a better competitive position with Japan, not just in automobiles but other industries, and over time that has some impact despite the fact you have this given, in our terms rather anticompetitive in some respects, framework for industry. If you can get rid of the official barriers and work hard on some of the cultural and customary or business practice barriers we can make some progress.

I think there was some evidence of that before the economy slowed down so drastically. A few years ago we were beginning to improve our trade position.

I think part of the answer in Japan has to be to in effect draw them into a larger negotiation, in my view, with other Pacific Rim countries in particular that are very large traders with Japan. Some of them are going to be in a better competitive position vis-a-vis Japan than we are. But collectively we have an interest in getting their markets more open. Collectively, we have an interest and Japan has an interest with us in more satisfactory dispute settlement procedures. So, there is something to be given on both sides.

This is no quick fix, but I would hope that by emphasizing some kind of Pacific arrangement—I am not talking about a full-scale free trade agreement, certainly not at this stage. But something where you can enter into a larger negotiation building on what already exists in APECC and elsewhere. We can make more rapid progress in changing some of those Japanese practices that you are talking about than we have so far.

Now, the other side of it is that we cannot resort to unilateral restrictions any time we want to either because that will be their demand, that they be brought into some larger framework, building on the kind of thing that we have done, I think, in the early days to see how successful it is in the Canadian Free Trade Agreement where they were very insistent that a new dispute settlement procedure be introduced. I think there is a general interest in the rest of the world in that kind of thing. It is one of the bargaining chips we have.

Senator KERRY. Mr. Chairman, I guess we did not go by the clock here. I want to try to keep a dialog proceeding and we will sort of self-police ourselves. And I will just ask a last question, if I may, and then turn to Senator Gregg.

On the Bretton Woods issue, as you look at this playing field and you look at these differences now between our countries, and you look at some of the problems of both the bureaucracy and choices before the IMF and World Bank, and also measure the world as it was at the end of World War II, where we were the only industrial power, economies were in shatters. We were able to set the playing rules and people essentially had to agree with us because it was our ball game. The big boy on the block could make the rules.

Now, we are not and we are seeing differences of approach here. Some have suggested that it is time for a new conference. We look at the interest rate problems, the interrelationship between our desire to have Germany move on its interest rates to move things and so forth.

We are all related in a different way than we were 40 or 50 years ago. Is it time for, is there an imperative to have a new agreement, if you will, another Bretton Woods by which we set out the playing field for this new industrial world that we live in where all of our economies seem to be struggling with these unfair practices in efforts to get advantage?

Mr. VOLCKER. In the monetary area and in the investment area my answer is no. I am afraid you are not going to be very happy with this answer. I doubt it. I doubt it because I, myself, don't have any very clear idea as to what kind of agreement you would seek in the monetary area in particular that would have a practical chance of application.

Now, maybe that is just a shortcoming in my own imagination and thoughtfulness at this point, but I find as I talk to other people I do not see the kind of extreme sense of need, rightly or wrongly, or the kind of convergence in thinking that would produce a fruitful result at the moment in terms of writing a new monetary system.

I think that may be unfortunate because I, for one, do feel rather strongly that the instability in the international monetary system, as reflected in the instability in exchange rates, is in an insidious way damaging to trade and damaging to prosperity and growth. That is a very hard point to prove.

I believe it, but I do not find an enormous consensus on that point of the kind that would support, as you put it, a new Bretton Woods which was quite extraordinary in the history of the world and, of course, was put together at the end of a war and with the United States very dominant with one partner that really mattered at that point. It was possible to do things it may not be possible to do now.

In terms of the trading area, I suppose I look upon this present Uruguay Round, which is an extremely ambitious round, as fulfilling part of that role, but it probably is just an overture to what we should be thinking about in all of these newer areas that you referred to earlier including, quite importantly, environment and how that bears upon trade, and what environmental rules are involved.

But the borderline between what really should be confined to trade policy and other policies has gotten very foggy, and if we could straighten that out I bet it would help a lot.

Let me just say one thing that bothers me in a more fundamental way. We all talk about the glories of free trade and the liberal trading order. We all learned it in college and universities. It is in all the textbooks and all the rest.

Against the background of what you emphasize in your opening statement, a relatively poor performance of the lower paid workers in the United States in manufacturing industry, what is the implication of a liberal trading order when we face a situation where an enormous amount of potential manpower is coming onto the market very rapidly in the world? It is not millions or it is not tens of millions, it is hundreds of millions when we are talking about China and India. And that is beginning to happen at a great rate of speed.

Those people are obviously very energetic, very intelligent. They are rapidly getting trained. What are the implications of this enormous potential kind of supply of manufactured goods that can be relatively easily produced, that includes some fairly sophisticated goods, being absorbed in terms of our own workers that compete with that supply?

Well, the answer is they go do something else. They get better trained. There are a lot of service jobs that need to be filled, and the market will take care of it.

I tend to believe that still. That is what theory says. But I think we ought to do a little more thinking here about what the implications are of that, because I think behind a lot of the current restiveness lies that fear. And I do not think we have really effectively answered that as yet. It is really a new phenomena.

This is not Hong Kong with a few million people. It is not even Korea, with 30 or 40 million people. It is certainly not Singapore, with 2 or 3 million people. You are talking about 1 billion people in China, and another three-quarters of a billion or whatever it is in India. And to say nothing of the much smaller population mass of the old U.S.S.R.

Senator KERRY. Well, I could not concur with you more, and I think Lester Thurow and others have been addressing that. I know Bob Rice has been talking about it. When you look at the revolution in the southern provinces of China and recognize the economic growth rate there and what they are currently targeting, it seems to me even more clear that we need to understand the rules.

Mr. VOLCKER. I mean, I think the old theory that this will work out to everybody's benefit in terms of aggregate income is right. The only question I have is how it affects income distribution in developed countries including the United States.

Senator KERRY. Senator Gregg.

Senator GREGG. Well, you have certainly raised a lot of interesting issues. Let me touch on a couple of them. First we would be happy to have another Bretton Woods and be happy to sponsor it again. [Laughter.]

In fact, I think the FDIC could probably work on this one because they presently own the Bretton Woods or did until a couple of weeks ago.

Mr. VOLCKER. Well, I must say, if I may add to my comments, that I am peripherally involved anyway in at least one group that is encouraging a relook at the Bretton Woods institutions, and they hope to have a concluding session at Bretton Woods. I do not think it will amount to the prosperity of New Hampshire or even the Bretton Woods hotel, but it would be a nice setting.

Senator GREGG. We will welcome them. If I understand what you are saying, it is that you think that as we enter these agreements such as the North American Free Trade Agreement, that we should not make the trade issues conditioned on environmental issues and labor issues. Is that correct?

Mr. VOLCKER. Yes. Well, I have no objection, obviously, to an effort to clarify environmental policies in Mexico, their labor practices. I certainly have no objection to considering and even applying trade adjustment policies in the United States as part of that agreement if that is considered suitable.

But I think there are limits as to how far you want to go in using the so-called leverage of a trade agreement to get into areas which I think logically are somewhat separate. There is some overlap. I think that is a dangerous kind of precedent to follow.

Senator GREGG. And if I also followed your comments, it was that first you think the Uruguay Rounds are extremely important, as I do also, but you think it is a preamble to what should be a greater and more expansive discussion. And if I heard you right, you were saying we should enter in with Japan and with the Asian countries in some sort of more expansive discussion.

Mr. VOLCKER. Right.

Senator GREGG. Can you sort of elaborate on that a little bit?

Mr. VOLCKER. Well, I do not know how much I can, but I think we are moving away from some of the traditional trading issues, at least on paper. Tariffs are low. I mean, that was the big issue 50 years ago, get tariffs down. Tariffs around the world, with some exceptions, are now low enough so they are not a great impediment to trade. We have had more and more nontariff barriers. I think that still comes within the traditional GATT framework.

But when you begin talking about overlaps with environmental policies, with what might be thought about as domestic industrial policies, as to what degree are subsidies legitimate and illegitimate, there is something to be said about that in existing trade rules, but it is pretty foggy. And I do think that while we ought to try, as I just said, to keep the traditional trade agenda separate from some of this other agenda, there are overlaps.

And I think that is the next challenge that we had better examine. To what degree are these connected and to what degree are they not. And if they are not connected, there is still a lot to be done on environment to take that example. There has already been a big conference on it recently, but that is an area where clearly we are going to have to move ahead.

I think the focus of attention is going to have to go in that area and, I would hope, maybe it is overly optimistic, to traditional trade agenda in terms of tariff and nontariff barriers, and into more emphasis on how we enforce the rules that exist which gets you into dispute settlement procedures in particular. That is one area where some kind of broader understanding and negotiations

between the Pacific partners might help lead the way toward a more general global understanding.

But I think the urgency may be greater in the Pacific, and maybe there are possibilities for progress and tradeoff that will be possible and easier to achieve. All I am saying is easier to achieve not just in a bilateral, head-to-head negotiation between the Japanese and the United States, but a negotiation that brings in other countries in Asia that are very much involved in the same set of problems. China is kind of a special case. Should China be brought into this or not? I do not know.

Senator GREGG. So, should we convene, like, an Anchorage session?

Mr. VOLCKER. Well, we already have an APECC. Asia Pacific Economic Cooperation Council—whatever it is called. Most directly strengthen that. It meets once a year, I think, and has a general discussion. People go home. My sense is it has not been very operational and effective in that sense, but it is a core upon which one can build.

There are other avenues too that other people have proposed. But yes, I would not go for—I am not suggesting the formality of a free trade agreement, free trading area, but I think we could build on very fragmentary organizations and thinking that already exists, and formalize it a bit.

Senator GREGG. One other area you talked about, which I think really is the gravamen of all of this dispute that is going to evolve over the next few years in trade, and that is the point of our ability to have our folks who are not quite as well educated as everyone else or as other segments of our society competing with the millions and hundreds of millions, as you say.

Professor Thurow last week said that two-thirds of our workforce is a Third World workforce. How do you envision without protectionism, without going down the road of what is being proposed by some folks, some new form of protectionism for this segment of our society, how do you envision us remaining competitive in a totally free marketplace? Obviously education is one of the answers, but have you thought this through?

Mr. VOLCKER. I think we can probably remain competitive in the trade sense. That is not what worries me so much, whether we can balance our accounts because I think there are things, if we do our job effectively and if we save more, balance the budget and all of that kind of thing, I think we can be on the leading edge of many important trading industries of high value added, and we will be quite successful building on what we have done in the past, such as our technological lead, our aerospace, our electronic, our service skills in many areas.

What worries me is whether we will bring along the workforce—I do not know whether it is two-thirds you say Professor Thurow referred to, but a large amount of people that are not going to be on the leading edge of the things that we are particularly strong in. And that is the question I am more interested in than overall competitiveness. What is the special competitiveness of the poorer sectors, the least skilled part of our workforce? I think that is where we need a little reassurance and a little thinking. It may be OK because they are different kinds of things; the kinds of things

that have to be done here. But now, of course, that gets into immigration policy too. If you have many, many people abroad breaking down our immigration barriers to the extent they are appropriate, then you have got the competition right here for that same group.

The traditional answer to this question would have been rapid growth abroad, and I think we have seen that. Enormous increase in incomes, in Taiwan and Korea, to take two major trading countries. They just have a very rapid rate of growth in real income that projected out may not catch up to us but they will make a much more even playing field in terms of labor costs.

The only question I am raising is, can you expect that process to go on so rapidly and forcefully when you are talking about countries a multiple the size of Taiwan and Korea?

Senator GREGG. Thank you. Can you give me five specific things we should be doing as a government that would address the issue of investment and savings?

Mr. VOLCKER. The most important thing, before you get to the other four, and this is the whole burden of my statement, you have got to do something about the savings investment imbalance. And I think you are just playing around the edges of that problem until you do something about the budget, because I do not think the fundamental habits of the American people as to how much they save are going to be that easy to change. And you are not going to change it, I think on the evidence, by tinkering around the edges of the tax code.

So, I would say, No. 1, you have got to deal with the budget problem.

No. 2, you ought to look at the tax structure so it is not so peculiarly directed against savings as the American tax structure is in my judgment. So, to the extent you are going to have to raise taxes, and I think you are going to have to, you had better look at taxes that are not destructive of savings. And, in fact, it would help to replace some of the present taxes that bear down upon savings with taxes that bear down more precisely on consumption.

So, that is one and that is two. And the other three are simply on a different radar screen so far as I am concerned. They are relatively small and—well, I should not say small. You can get into education, obviously, very important. I have not got anything to say about education except that I think it is not in very good shape, and I wish somebody would—a genius would come along and tell us how to improve it, and actually get that implemented in some reasonable period of time.

But you are talking about great generalities. The things that I know about and I think that we can do something about are what I would put one and two, the budget and tax system.

Senator KERRY. Thank you very much, Senator Gregg. Senator Rockefeller.

Senator ROCKEFELLER. Thank you, Mr. Chairman. Chairman Volcker, there is a lot of discussion now about China and the MFN. And you have evoked in your remarks this morning, and I did not hear your testimony, sort of the nature of human beings, the way people change or the way they do not change. By changing the tax system, can you get Americans to save more and consume less, that kind of thing.

China really has not had any concept of human rights for 5,000 years. I mean, you can do all of that. You can look at their paintings and it always, you know, tiny people, huge landscape. Man always in perspective to much larger forces. And you go back over thousands of years to different emperors. There have been no war lords when there was not an emperor system; no sense of human rights.

Now, when it comes to this very interesting matter of an economy which is growing at 13 percent overall, and then you go down to some of those southern provinces and it is 25- to 40-percent growth, and all of a sudden you are looking at an enormous, enormous potential for exports.

I remember Pepsi, for example, "got the franchise on China." And when they went over there to do it, the Chinese said, "Well, we will give you the franchise but you have got to quarry marble for us." Of course, Pepsi has never quarried marble, but with 1.3 billion, 1.4 billion people staring them in face they decided they would quarry marble. So, they are quarrying marble in China, and they have got the franchise. Now, getting the franchise in China is just an incredible statement about markets for exports in our future.

My side of the aisle traditionally has said that human rights has to come first, and Tiananmen Square, et cetera. The Chinese have not apologized, this or that or the other, and until you get human rights in order you cannot really get other things in order.

I am kind of rethinking all of that in my own mind and trying to decide in a very complicated world where there is the question of human misery on many fronts, Bosnia, in our own inner cities, and what is the broader American interest? How do you describe the broader American interest?

And at a time when we seem to be unable to produce high-wage, high-skill jobs, and our next panel will talk about that, can you just reflect in your own mind on the balance in terms of the greater interests of our country with respect to MFN, China, its export possibilities because of its growth, and the matter of human rights?

Mr. VOLCKER. Well, it is clearly a very difficult and controversial area upon which I have had to do a little thinking apart from the thinking one does as a citizen, because I am somewhat involved in economic relationships with Hong Kong that have a direct bearing on this question. So, I want to declare that interest.

But it does seem to me that the argument is very powerful and convincing that the most important single liberalizing element in China is, in fact, their desire to grow, their increasing conviction that the way one grows is by developing a more liberal economic system, and opening themselves to the rest of the world.

And that has gone on, at least in the Chinese timeframes, quite rapidly with very dramatic results in parts of China. And that will bring in its train progress in some of these other areas that very much concern us including that most resistant one of all, I suppose, human rights.

But ultimately, it does seem to me there is an inevitable linkage between a decentralized, market-oriented economic system and the ability of people to obtain human rights in other areas that—first of all, they are richer. They have some capacity to make their views known and to exert their rights, actual or potential, in other areas.

But the mere fact that they are able to think for themselves and operate for themselves to a greater degree in the economic sphere is going to bring in its wake, I think, both the demand and the ability to demand some freedom in other spheres.

So, I do think in an ultimate sense, it would be counterproductive to cut off trade and cut off openness, or discourage the openness of the Chinese on the economic front in the hopes that that would improve the human rights situation. In the long run, if you were successful in isolating them economically I suspect it would have the opposite result.

That may be a hard case to sell in the near-term context where people are upset, and rightly so, particularly about human rights violations. Nonetheless, I think it is a valid, fundamental point.

In areas more directly associated with trade which overlap to human rights, the use of prison labor, subsidies or forced labor, I think on a case-by-case basis we ought to be able to make some progress within the framework of established rules, that some of these things such as extreme cases of dumping are not appropriate on grounds of trade policy without doing something so sweeping as withdrawing MFN, which of course there is not much precedent for withdrawing.

I mean, if we think about it as a special privilege, a special privilege virtually everybody in the world gets including Libya and the Middle East, and other dictatorial states, so it is rather extraordinary to think that is the way to deal with authoritarian and dictatorial regimes. At some point maybe you do, but I would hope we are not at that point with respect to China.

Senator ROCKEFELLER. Well, you bring up an interesting point when you talk about—what you basically say is prosperity and the little dishes that bring down CNN and the millions of them now in China, and the increase of information is what eventually leans people toward generosity. Perhaps a new generation of leadership would be doing that in a few years. But then you said that we need to knuckle down on things like dumping and subsidies.

And that is an interesting one, too, because it brings up the question of the GATT. The Chinese, it would seem to me—I mean, the Japanese are a very mature society, a very democratic society in the sense of a Confucian society. Their GNP is now that of an industrialized nation, not very great. They are looking at all kinds of problems—an aging workforce, having to import workers. And they do not budget on subsidies. Their ambassador in Geneva and their vice minister at international finance, the ministry of finance, they do not budge.

Mr. VOLCKER. You are talking about Japan?

Senator ROCKEFELLER. Japan. In other words, the Chinese are just in a formative stage, so to speak. And to expect them to sort of relinquish on subsidies without challenging them when the Japanese were very mature in all of this and have watched this and observed this over many years are not doing anything about it.

Some people say, indeed, that they will not. And therefore what you do, and this is something you suggested with APECC, is that you say to the Japanese, or to the Europeans on their agriculture, fine, if you do not want to do GATT then we will just take a de minimis GATT and we will just do what we can agree on and do

no more. And if that becomes impossible then what we will do is we will—and it is case in negative terms. We will sort of assemble ourselves into regional or natural trading groups, which with us would be our hemisphere and Asia, where we are anyway. And then you indicated that perhaps that is not such a bad thing.

Now, what I want to get from you is what do you mean by not such a bad thing, which you did not actually say but implied, and should that be a policy which we really throw at the Europeans and the Japanese aggressively, saying if you do not come to agreement on subsidies and dumping that we will, in fact, go toward these regional blocks?

And, one, would it work? Would it back them off? And second, if it did and we went to regional trading blocks, not formalized as you indicated, would that be such a bad thing?

Mr. VOLCKER. I see these as complementary. You raise a question. I am glad you raised it because I want to clarify my view. I do not see these regional arrangements as a substitute for the GATT or a substitute for multilateral——

Senator ROCKEFELLER. Neither do I, but I am saying in the event these others do not work out.

Mr. VOLCKER. In the event they do not work, maybe as a resort—if it is a last resort, you had better make it as wide as possible. Not just North America but North America and the Pacific, which is better than just North America, and the Pacific having their own regional trading area which is the other way this could go.

But one of the reasons I feel so strongly about GATT is it is not going to solve all our problems by a long shot, but unless we have that generally agreed, multilateral framework this movement toward regional trading areas worries me because I think sooner or later they will become combative with each other. They are not that way now, at least in the North American concept. We worried a lot about that with respect to Europe in the past, and I think with some justice we worried about it. It has not happened.

Senator ROCKEFELLER. But the Japanese are not going to give up on subsidies or dumping. They are not going to change their point of view.

Mr. VOLCKER. I think I disagree with you in the sense that the Japanese, I have not got enough expertise in this area, but it strikes me that perhaps they are much less flagrant violators, if they are, of subsidies and dumping than they used to be.

Senator ROCKEFELLER. But this has to do with not just the Japanese, but the Japanese are blocking the changing of the Dunkel draft which would take into account dumping and subsidies. I am sorry, I should have said that.

Mr. VOLCKER. That may well be true, and I think it is in our interest that we have a strong draft. But there are obviously people in the United States that are not particularly eager for the GATT to get too strong an authority in this area because we would rather do it unilaterally. And I suspect that view is pretty well represented in the Congress.

And so there is some quid pro quo here. There is a lot of nervousness in the rest of the world as to whether we are seriously interested in really strong GATT rules, or at least whether we will fol-

low them if we have them. And I think there is all the makings of a bargain there.

But I do not have expertise enough to know just where it stands at the moment and what the possibilities are. But I am sure that having good and effective rules in this area is in our interest. And the rest of the world thinks it is in their interest that we do not go off on our own in this area. So, there ought to be some makings of a bargain.

Senator ROCKEFELLER. Mr. Chairman, I have overextended my time, but I will just say again to Chairman Volcker, it is absolutely impossible for the Dunkel draft to pass out of the Senate Finance Committee on either side of the aisle at this point. It is absolutely impossible. It will not happen.

So, either there is going to have to be a difference in the way dumping, and subsidies, and the Europeans on agriculture matters are handled, or there will not be a GATT round in my judgment. I mean, that is just my own judgment.

If that were to occur, would you consider that to be—well, I think I know your answer. You want it to happen and you would rather stick with that point of view.

Thank you, Mr. Chairman.

The CHAIRMAN [presiding]. Mr. Volcker, we appreciate very, very much your appearance here this morning, and we will leave the record open for questions. I know you have to make another engagement, but the committee is very appreciative of your coming and being with us.

We will now have the panel come forward. Dr. Thurow and Dr. Prestowitz. And if they are not doctors, we will make them doctors.

Mr. VOLCKER. I appreciate your courtesy.

The CHAIRMAN. Thank you very, very, very much.

Senator KERRY [presiding]. Gentlemen, thank you very much for being with us, and we look forward to your opening statements.

STATEMENT OF DR. LESTER THUROW, DEAN, SLOAN SCHOOL OF MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Dr. THUROW. I think you need to start with a realization that we are moving from an era where comparative advantage was basically determined by natural resources and what economists call factor proportions, which means capital-labor ratios, into an era of what I would call manmade comparative advantage.

For example, if you look at 19th century America, we grew cotton in the South because the climate and the soil was right, we made it into cloth in New England because the water power was there with the capital, New York was the biggest city in America because it had the best harbor with the best water connection to the Midwest, you were going to make iron and steel in Pittsburgh because given the coal, the iron ore, the rivers and lakes, there was no other place to make it, Chicago was going to be the transportation capital of America, Texas was going to be oil.

I would like to argue to you that in that world economic activity and its location is more or less immutable. There is very little role that governments are going to play in where economic activity occurs.

There are a series of events, however, that have basically erased that world. The first series of events are the green revolution and the material science revolution that have basically kicked natural resources out of the equation.

The second event is a world capital market, which means we no longer make capital-intensive products in rich countries and labor-intensive products in poor countries because everybody has access to that world capital market.

We also now have a world where human skills are more important than physical skills, and this whole distinction between capital and labor has more or less collapsed, and we are entering into an era where if you are looking at skills, it is the one source of long-run competitive advantage.

As was mentioned earlier, if you look at the American workforce, about one-third of us you can call a world-class workforce, two-thirds of us you would have to call a Third World workforce, and the problem is in the global economy that Third World workforce inside the United States will be paid Third World wages or it will be unemployed, because you can do those things in the Third World and import them into the United States.

Now, if you look at what the rest of the world thinks about in terms of strategy, they usually argue that there are four things you want to look at when you are thinking about industry strategically. You are interested in industries that have high value added, because that means potentially they can pay high wages and high profit.

You are interested in industries that have high rate of growth or productivity because that means wages and profits can go up. You are interested in industries that have a high-income elasticity of demand. That is simply economic jargon for saying markets are going to expand rapidly, and you are basically interested in complementarities where success in one industry will lead to success in other industries.

Now, if you look at countries like Japan or Taiwan that have tried to systematically figure out what industries meet these four criteria, they generally come to the conclusion that the following seven industries are on their list of desirable industries. I will read you the Japanese list: microelectronics, biotechnology, the new material science industries, telecommunications, civil aviation manufacturing, machine tools plus robotics, computers plus software.

Now, if you think of those seven industries, what is the common denominator of them, other than everybody would like to have them? I think the basic common denominator is that these are all brain power industries. They could be anywhere on the face of the Earth. They could be on the Moon, as far as that is concerned. They will be that place where somebody organizes the brain power to capture them, and what I would like to do is talk about that notion of organizing the brain power to capture them from top to bottom.

Now, one of the things you have to think about when you talk about organizing that brain power is that in this era of manmade comparative advantage and brain power industries, Government has a very important role to play when it comes to economic location.

First of all, Government plays a big role when it comes to having a skilled workforce. Second, Government plays a big role when it comes to having an R&D policy, and Government has a big role to play to make sure that you have the appropriate organizations to play in the world economy.

For example, if you think about two of the things that have been mentioned already this morning, a country that does not have a value-added tax from the point of view of international trade is stupid, because it is the only tax under the rules of international trade that is rebatable on exports.

Just for example, suppose the Germans collected only the value-added tax. That would mean that when Mercedes Benz sent a car to the United States they would get a complete refund of all the taxes they would have paid on that car. On the other hand, a General Motors car going to Germany would have to include in the price at which it was sold in Germany the payable tax, the property tax, the corporate income tax, and then when it got to Germany, in addition it would have to pay the German value-added tax.

So, an American car in Germany pays two taxes. The German car in the United states pays no taxes. Now, that is not the Germans cheating, that is the Americans being stupid and being unwilling to adjust our tax laws to reflect the reality of the world trade regime.

We also talked about the antitrust laws. The simple fact of the matter is that if 26 Matsui companies can get together and plan joint strategy in the United States, which they can, then you have to change the American antitrust laws to allow 26 American corporations, if they wish to, to get together and play the game in Japan, because we are out of the era when we can basically assume that the rest of the world is going to play by American rules, and in some of these places we are going to have to change the way we do things to correspond to the rest of the world.

Now, I would argue to you here, if you think about these policies it is important to understand that capitalism has a strategic defect. The big defect of capitalism is that with any reasonable interest rate the net discounted present value 10 years from now is so small as not to matter, and so if you look at capitalistic companies they do not plan more than 7 or 8 years into the future.

But the problem is a lot of the skills and R&D investment that are going to have to be made to capture these brain power industries have a gestation period a lot longer than 7 or 8 years, and I might note just for a matter of illustration that no hard-nosed capitalist mother or father would ever pay for 16 years of education for their children—16 years of investments without a return is not a capitalistic investment. It does not pay. You would not do it.

Real mothers and fathers will do it, and smart societies will do it, but capitalistic societies will never do it, and of course that is one of the reasons why in every country in the world education is a public matter as opposed to just leaving it to the market.

If you think of the role that Government has to play in this area, I think it is basically to remember that Government represents the interest of the future to the present, and that is the role you have to play, and of course that comes back to the Government deficit

and that is one of the places where at the moment the Government is not representing the interest of the future to the present.

Now, the problem of course is, if you are going to have an R&D policy that focuses on these industries, you have to have basically some kind of industrial strategy behind it, and in the last 50 years the industrial strategy in the United States has been called our military strategy, which informed our Government R&D policies, since about 40 percent of all the money spent on R&D in the United States came from the military, directly or indirectly.

Now, the great thing about the American military is, it knew what it wanted—a missile that lands within 15 feet, a submarine that stays underwater for ever, a spy satellite that sees everything.

It is similarly important that if you are going to do a civilian R&D policy you also have to know what you want. You cannot simply give money to researchers and tell them to do good things. You have to know where you are going to place your investments.

For example, I could bring you to MIT and walk you around, and I will show you some fabulous technologies. The problem is, some of these are going to lead to big, important industries, and some will not.

You have got to understand that you have got to decide where you are going to bet your investment dollars. This does not mean Government has to pick winners or losers, but it does mean it has to be involved, and I would suggest that you might think about looking at some of the European projects like Jessi, Eureka, Esprit, Prometheus.

In all of these areas the Common Market has picked a hot technology and said that we, the government, have a pot of money, and if three companies from two different countries will come through the door with a good project and half the money, we the government will match it, and so the companies are picking winners and losers, but the government is lengthening time horizons, expanding projects, and each one of those names that I just mentioned is a project designed to pick up one of these seven strategic industries which I mentioned earlier.

Now, the previous chairman of the Council of Economic Advisers, Michael Boskin, will go down in history for saying something which he claims he did not say, but it is now to the point. It will be the one thing in his entire lifetime that will be remembered, and that is it does not make any difference whether the United States makes computer chips or potato chips.

The fact of the matter is, if you read an economic textbook he is absolutely right, because supposedly the rate of return in every industry is the same, the wage rate in every industry is the same, and the only difference is skills and the amount of capital absorbed.

The problem, of course, is that in the real world rates of return and wages are not identical in every industry and it makes a hell of a lot of difference whether you make computer chips or potato chips, and that in a world of manmade comparative advantage and brain power industries gets you into this whole question.

Now, the problem on the trade side, of course, is that you cannot formulate a trade policy until you have first formulated an indus-

trial policy, because the question is, Where do you want to play the game?

For example, the United States restricts lamb imports from New Zealand, the Japanese restrict the imports of amorphous metals from the United States. Lamb does not meet my four criteria of high value-added, high productivity, high income elasticity of demand, complementarities. Amorphous metals do. One is strategic and one is simply protection.

There was an article not too long ago in the MITI magazine in Japan which said the United States has an industrial trade policy, it is just loser driven, and they use that phrase—"an American loser-driven industrial trade policy"—and I think that is basically the way the rest of the world sees us. We have a trade policy. It is just a loser-driven trade policy.

Now, the problem is, if you say, what should our trade policy be, you in Washington cannot figure it out, I in Cambridge cannot figure it out. The basic problem is you have got to put a process in place to do it, because it takes a lot of hard work and analysis and a lot of widespread consultations to see whether people are willing to participate. It involves looking at the American skill base and its technological strengths, it involves looking at your competitor's skill base and their technological weaknesses, and let me give you an example.

For example, suppose you want to be a leader in the telecommunication industry. What is the right thing to do? One thing you might do is, you might put more R&D money in telecommunications research.

On the other hand, you may say the right way to do it is the way the Germans are doing it, where you rewire East Germany with fiberoptics so you have 18 million people on a fiberoptics test bed so you can do things that nobody else in the world can do. In each individual industry, it is going to be different.

Now, in some of these things trade plays a role, in some of them it does not. I think we need to point to two things. In addition to having an industrial policy on the positive side, I think you have to think about trade and industrial policies on the negative side, and the Japanese call this strategic retreat. How do you get out of industries that you ought to be getting out of with the least possible pain to the human beings involved?

If you want to look at a well-executed strategic retreat, you would look at the Japanese involvement in the aluminum industry, where when they came to the conclusion that because they import energy they could never be the low-cost producers of aluminum they got out of that industry very rapidly, and the government played a positive role in getting out as well as getting in.

The next thing you have to think about is this whole question of how do you play defense, and of course Airbus Industries is the best example. We can sit here and say that the Europeans made a mistake, they should not have put all those subsidies into Airbus Industries, but the fact of the matter is they did, and the fact of the matter is, Airbus Industries is not going to go away, because you cannot go back and replay history.

So, then the question is, What do you do in these areas where some of your neighbors out there in the world have targeted one

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of your key industries, and basically are planning to drive your companies out of business?

But I would argue to you until you think about strategic trade, in some sense we are trying to put the cart before the horse. We have to think about what the American economic strategy is before we can really start to think well on the strategic side.

Then when you think on the strategic side, I think you then have to have a very different set of involvements involving American companies, and a lot of people outside of Washington, DC before you can really come to the bottom line and say, this is how we ought to set up our strategic trade policy in the United States.

Thank you.

[The prepared statement of Dr. Thurow follows:]

PREPARED STATEMENT OF LESTER C. THUROW

STRATEGIC TRADE POLICY

I. *We are moving from an era where comparative advantage was determined by natural resources endowments and capital-labor ratios (what economists know as factor proportions) into an era of man-made comparative advantage.*

A. In the 19th century the United States grew cotton in the south because the climate and soil were right, made cloth in New England because that was where the water power and capital were, New York was the biggest city in America since it had the best harbor on the east coast with the best water connection to the midwest, Pittsburgh was the iron and steel capital since given the coal, iron ore, rivers, and lakes there was no other place to do it, in the age of railroads Chicago was the transportation capital and hog butcher to the world, Texas was oil. The location of economic activity was essentially immutable.

1. The green revolution and the materials science revolution have knocked natural resources out of this economic equation. Having them doesn't make one rich; not having them does not force one to be poor. In real terms, from 1970 to 1990 raw material prices fell 40 percent and will fall at least that much again in the next 20 years.

2. World capital market means that no longer do we automatically make capital intensive products in rich countries and labor intensive products in poor countries.

a. Every country now effectively borrows in New York, London, and Tokyo and has access to the same capital.

b. As human skills have become more important, the distinction between capital and labor has become less relevant.

3. In the century ahead human capital, skills, will be one of the two prime determinants of economic location.

a. The US is simultaneously both a first world and a third world economy. One third of the labor force has first world skills and will be paid a first world wage but two thirds of the labor force has third world skills and will be paid a third world wage in a global economy where factor price equalization reigns.

B. Everyone would like to have industries that are expected to be high value added since only they can pay high wages, expected to have a high rate of growth of productivity since value added and hence wages will be rising rapidly, expected to have a high income elasticity of demand since jobs opportunities will be growing rapidly, and expected to have complementarities where success in one industry will give one an edge in other industries.

1. Those, such as Japan or Taiwan, who prepare such lists tend to come to the conclusion that the following seven industries meet these four conditions: micro-electronics, bio-technology, the new material science industries, telecommunication, civilian aircraft manufacturing, machine tools plus robotics, and computers plus software.

2. The common denominator of these industries is that they are brain power industries and could geographically be located anywhere on earth.

3. We are in an era of man-made comparative advantage.

II. *As a result the whole notion of national economic strategies must be different than it would have been even a few decades ago.*

A. Many of the elements that go into the creation of these brain power industries are dependent on government activities.

1. Government has to insure (1) that the necessary skills are present in the labor force, (2) that the necessary R&D is done, and (3) that the appropriate organizations exist to take advantage of both the available skills and knowledge.

B. Capitalism has a strategic defect. Using any reasonable interest rate, the net discounted present value of a dollar 10 years from now is so low as not to matter. As a result, no capitalist makes investments that do not pay out in less than 7 to 8 years.

1. But the skill and R&D investments that must be made to capture tomorrow's brain power industries often have a gestation period much longer than 7 or 8 years.

2. *Example:* No hard nosed capitalistic mother or father would ever invest in 16 years of education for their children. Sixteen years is simply too long to go without a return. Yet collectively, education clearly pays off.

C. As a result, government has an important role to play. It must represent the interests of the future to the present.

1. Government must take systematic actions to lengthen time horizons in the private sector.

III. *To have an effective national R&D policy one must have an industrial strategy.*

A. Giving money to researchers and telling them to do good things does not work.

1. In the past 50 years America's R&D policies have been driven by its military strategies. The great thing about the military is that it knew what it wanted—a missile that lands within 15 feet, a submarine that stays under water forever, a spy satellite that sees everything.

B. A civilian R&D policy similarly has to know what is wanted. Where is the global economic game to be played? What is the American game plan?

1. I could walk you around MIT and show you some wonderful technologies. But some will lead to big important industries and some won t. Someone has to decide where to invest.

2. This does not mean that government has to pick winners. In its projects such as Jessi, Esprit, or Eureka, the European Common Market announces that it has picked some hot technologies, has matching funds, and if three companies from at least two different countries will come through the door with a good project and half the funds, these private funds will be matched with government funds.

3. Government is not picking winners but it is expanding time horizons and the scale of activities that would otherwise occur.

IV. *Computer chips versus potato chips.*

A. Although he denies making the remark, the Chairman of President Bush's Council of Economic Advisers, Michael Boskin, will do down in history as the man who said that it did not make any difference whether America made computer chips or potato chips.

1. As economics is taught in our textbooks, he is right. In equilibrium rates of return to capital, human and physical are the same in each industry and the rate of return for sacrificing leisure (wages) is also the same in each industry.

2. In fact this equilibrium does not exist and it does make a difference. *Rates of return and wages are not identical.*

3. It is this difference between reality and textbook economics that makes an industrial strategy and a trade strategy necessary.

B. *But a trade strategy cannot be formulated unless an industrial strategy has been formulated. What is the American game plan and where does the United States want to play the game? Without an answer to this question, there is no possibility of generating a strategic trade policy.*

1. America restricts lamb imports from New Zealand while Japan restricts amorphous metal imports from the United States. Both are restrictive; only one is strategic.

a. No one believes that lamb meets the four criteria outlined above—high value added, high productivity growth, high income elasticity of demand, complementarities.

b. The Japanese believe that amorphous metals do meet these criteria and, as the Japanese say, the United States has an industrial and trade strategy.

2. *It is just loser driven.*

V. *Before anyone could say what America's strategic trade policy should be, one has to know what the American game plan is for playing the global game filled with brain power industries in an era of man-made comparative advantage.*

A. That game plan requires a lot of hard analysis and widespread consultations if it is to be formulated.

1. One was to analyze both the American skill and technological strengths in different industries and the weaknesses of one's principal competitors.

2. One has to understand where the keys to achieving success are located.

a. *Example:* Is leadership in the telecommunication industry of tomorrow to be gotten in strengthening America's laboratory leadership in the key technologies in this industry or in building the a fiber optics test-bed such as that Germany is now building in eastern Germany?

B. An industrial and trade strategy also requires a theory of strategic retreats. How does a country get out of the industries that it should get out of with less pain and permanent damage to human capital?

1. The Japanese aluminum industry is a good illustration of a well planned strategic retreat in the wake of the energy shocks of the 1970s.

C. *Where and how is the game to be played? Without an answer to that question, there is no such thing as a strategic trade policy for the United States.*

Senator KERRY. Thank you very much, Dr. Thurow, we appreciate that.

Mr. Prestowitz.

STATEMENT OF CLYDE PRESTOWITZ, PRESIDENT, ECONOMIC STRATEGY INSTITUTE

Mr. PRESTOWITZ. By this time in the proceedings, usually everything worth saying has been said. I would like to submit my full statement for the record, but just concentrate for a moment on the question of how to address the trade question.

The trade problem in the United States has two aspects. One is the size of the trade deficit, the other is the composition or the content of the trade deficit.

With regard to the size of the trade deficit, the classical view which was stated by Chairman Volcker this morning is that high-savings countries have trade surpluses and low-savings countries have trade deficits, and therefore the solution is to increase savings, and in the context of the U.S. experience, that means to reduce our budget deficit.

While I do not disagree with that, I think that if there is one single problem that we as a country need to resolve, it clearly is the problem of our budget deficit and our tax system. I do not think there is really any room to disagree with that.

Having said that, I think it is also worth understanding that our savings behavior is in some ways affected by the trade situation. There is in economics a well-known accounting identity which says that savings minus investment plus the budget Government surplus or deficit equals net exports.

This is an equation. It is tautologically true, and typically the discussion of it is done in terms of the assumption that the action in the equation moves from left to right. That is, that savings, investment, and Government spending behavior influences trade, and of course it does, but just because it is an equation, that means that mathematically it must be possible that trade behavior influences the other side of the equation as well, and it does, also.

Just to cite a quick example, U.S. supercomputers have been blocked in the Japanese market. If by some miracle the Japanese market were open tomorrow, U.S. supercomputer manufacturers would sell more supercomputers in Japan. They would make more money, their costs would be lower, they would pay more taxes, they would save more at the corporate level, possibly their employees would save more, U.S. savings investment and Government spending would be affected as a result of this activity on the trade side.

So, that suggests that even in terms of reducing the size of the trade deficit, dealing with trade structures, trade problems, unfair

trade, structural differences, trade barriers is an important thing to consider.

Second, even more important in some ways than the size of the trade deficit is the content of the trade deficit. We could, after all, theoretically balance our trade with Japan—putting the spotted owl aside for a moment—if we chopped down enough trees in Oregon and Washington, if we gathered up enough waste paper—which is the biggest export item from the Port of New York City—and if we gathered up enough empty Coke and Pepsi cans and shipped the scrap aluminum—which is our fastest-growing export—to Japan, theoretically we could balance the machine tools, Lexises, video tape recorders, et cetera, that we import from Japan.

It is not clear that that would necessarily make us economically better off. In fact, in a recent meeting with some leading trade commentators, one of them said, "Why do we not ship more Alaskan oil to Japan?"

Well, we could ship Alaskan oil to Japan, and that would cover to some extent our bilateral trade deficit with Japan. It would not, however, reduce the overall U.S. trade deficit by $1. We would have to substitute for the Alaskan oil we export by importing more Venezuelan or Mexican oil, and it would not create another job in the United States, and it would not do anything about opening up the Japanese market for the computers that in fact would create more jobs in the United States.

So, the point is that in order to really deal with the productivity and the welfare implications of our trade problem we have to deal with the question of the content of trade and that gets you down to dealing with these questions of industrial policy subsidies, dumping, structural barriers and so forth.

There are essentially two potential approaches. The classic U.S. approach has been to argue that we want to move toward a liberal trading system and that to do so the United States should set the example by maintaining open markets here and arguing, negotiating with our trade partners to persuade them to remove their trade barriers and to change their policies.

The concern is that if we should respond in kind to countries with whom we are negotiating by imposing trade barriers or in some way acting reciprocally, that this will precipitate a trade war and that trade war will result in severe losses both to ourselves and to our trading partners, and therefore we want to avoid that.

This, of course is an attractive approach. It appeals to the idealism and the sense of progress of the American public at large, but let me recall to you an experience I had several years ago which I think lies at the heart of this issue.

You may recall—I am sure all of you do—the famous MOSS negotiations with Japan, market-oriented sector-specific negotiations. Some people said it stood for more of the same old stuff, but the idea was that we were going to identify markets in Japan where U.S. industries were very competitive, negotiate intensively to remove all barriers, and then U.S. industry would establish beachheads and spread out and penetrate the Japanese market.

This idea was first discussed in the fall of 1984, as President Reagan was preparing to meet with Prime Minister Nakasone, and

the question before the Cabinet was, What should the President say to Nakasone?

There were two schools of thought. One school of thought was, look, we have been negotiating with these people forever. We cannot identify all the trade barriers in Japan. If we could, we could not get them all removed, and if we could, new ones could be created faster than we could get the old ones removed.

So, why do we not forget all that nonsense, and why do we not just have the President say to the prime minister, look, Mr. Prime Minister, I have got a problem. Last year when you had a problem, I helped you out. I called off my dogs. I did not allow my Secretary of Commerce to initiate dumping cases against your machine tool industry. I stopped my Trade Representative from initiating unfair trade action against your semiconductor industry, and now I have a problem, and my problem is that you people do not buy enough and you sell us too much. We have got this huge trade deficit. It is causing political problems, and I need some help.

Why do you not set a number? I do not care what the number is. You Japanese are always having visions. You have visions of the auto industry, and the machine tool industry, and the semiconductor industry. Have a vision of imports, and pick a number, and just try to reach it.

Well, that stream of thought was strongly opposed by others in the Cabinet who said no, that would be managed trade, that would be protectionism, and that what we needed to do was to promote market forces in Japan by entering into these MOSS agreements.

Now, the question then arose, what do we consider to be barriers in Japan, and I asked this question of some of the officials at that meeting. I said, "You know, are you talking about classic trade barriers, are you talking about quotas and tariffs and border measures, the classic things that the GATT deals with, or are you talking about the administrative guidance, the distribution system?" What does it mean when you say we are going to remove all these barriers?

The answer was, all barriers, including the keiretsu, the administrative guidance, et cetera. When I heard that, a thought went through my mind, which was the following. Here I am, sitting in the White House, surrounded by highly educated, cosmopolitan men and women, at the center of power of the strongest country the world has ever seen.

If I were to stand up in this meeting and suggest that we send our trade negotiators to Japan to convert them all to Christianity, I would be laughed out of the room. Everyone in this room is so sophisticated and so smart that they know that that is an impossible task, a fool's mission, but in fact what our Under Secretary of State for Economic Affairs and our trade negotiator and our Deputy Secretary of the Treasury have just done is precisely that.

They have just decided that we are going to send our trade negotiators to Japan to change the whole Japanese society, not in religious terms but in very fundamental philosophical terms about how society relates to its government, how an economy relates to its government, and when those negotiators are unsuccessful, then these very sophisticated, intelligent people are going to be forced

into a corner which they will have to threaten retaliation or else appear to be impotent and failures in their negotiating strategy.

It seems to me that where we come to is we of course want to move in the direction of liberal trade, but we have got to recognize that there are other countries out there who conceive of economic strategy with the relationship of industry and government in very different ways than we do. It does not mean they are bad, it does not mean they are evil. We do not want to be in a position of having to retaliate against them.

But at the same time we have to recognize that those different conceptions of how to run an economy have an impact on us. And therefore, our position ought to be that we want to negotiate to establish roughly equivalent conditions of competition. That is often interpreted as managed trade and defined as wanting to negotiate market shares. But the truth is that we engage in a lot of managed trade today and have for a long time, and it does not necessarily mean negotiating the specific market shares or cartelizing the world, for example.

We have been running an international airline network ever since the end of the second world war, and in international airline agreements we negotiate on a reciprocal basis. Essentially equivalent conditions of competition, the numbers of flights, the numbers of destinations, the cabotage rights, the landing fees, are all negotiated reciprocally so that each country's airlines competes on essentially the same basis. We do not negotiate a market share. The market shares fluctuate. But the reason we do that is because we know that to be a real country you have to have an airline.

Air Zaire, Air Sri Lanka, economically, these do not make sense. But you cannot be a real country without an airline. We know that we could go to the French and we could tell them that it is bad for governments to own airlines and they ought to sell Air France and privatize it and if they do not do it we are going to retaliate. But we know that such an action would be nonsense. The French would not listen to us. They would reject our proposals, and it would embitter relationships between us.

And so instead of doing that we say well, OK, we recognize that you folks think that governments should own airlines, and that is fine. But therefore we cannot give you unilateral free trade because if we do your government subsidized airline will wipe out our airlines and we think that having airlines is important, too. And so we say let us, however, trade, and let us negotiate an arrangement between us which harmonizes the difference in the economic structures or the economic philosophies that we have toward airline trade and we do it and it roughly works. And I suggest that that kind of a model should be applied more generally in all instances in which we face structural or economically philosophical differences.

Let me just make one last point with regard to MFN on China, which I know is a hot topic. It was a mistake, in my view, to have given MFN to China to begin with. We gave MFN to China for political reasons without considering the economic implications. We did it because we wanted to achieve geopolitical objectives, and we felt that we could give them economic concessions in order to achieve some kind of geopolitical objectives.

You can debate whether that was good geopolitically or not, but what it means is that we treat China the same way we treat the UK or Canada or Germany in our trade. But China has a very different economic structure and economic philosophy than those other countries.

Now, it seems to me, it is very difficult, as Chairman Volcker said, to withdraw MFN from China because it then becomes a major cause celebre between the two countries. Moreover, without compelling the Japanese and the Europeans and others to impose the same kinds of human rights criteria on China that we do, all we will succeed in doing is isolating ourselves from the Chinese market. So, it seems to me that that is not a good direction in which to go.

However, we clearly, in my view, should, while maintaining MFN with China, condition it or inform the Chinese that we are not going to extend them all the privileges of the GATT, that we are going to monitor on a continuing basis for dumping, for subsidies, for slave labor. We are going to insist that our trade with China be conducted on a reciprocal basis, and that, for heavens sakes, let us not allow ourselves to get captures by the notion that for political reasons we want to put China in the GATT before compelling China to adopt an economic system that truly is compatible with GATT.

Thank you very much.

[The prepared statement of Mr. Prestowitz follows:]

PREPARED STATEMENT OF CLYDE PRESTOWITZ, JR.

Mr. Chairman, my name is Clyde Prestowitz, Jr. and I am president of the Economic Strategy Institute, a Washington-based research organization developing new strategies for dealing with economic, trade, technology, and security issues facing our nation. I want to thank you for the opportunity to testily before you this morning on our trade and technology policies.

Our national goal is not controversial—we should be striving to raise our productivity and to increase job creation thereby raising our overall standard of living. In order for our trade and technology policies to be effective and help us achieve this objective, however, they must be part of an overall economic strategy. The greatest trade policy in the world will not work if there is hyper inflation. Similarly, the greatest technology policy in the world will not work if there is inadequate capital to invest or if the cost of capital is six times as high as the rest of the world. Clearly, the only sensible approach is to have an integrated, economic strategy that begins with the fundamentals.

We must increase our current levels of investment. In order to invest we need capital formation and savings rates at least equivalent to other leading industrial nations. We, therefore need to pursue policies aimed at reducing our budget deficit, increasing the American savings rate, and doubling our rate of capital formation. We, obviously, also need to pursue low inflation policies with a sound dollar, low interest rates, and moderate monetary growth. These fundamentals are not debatable, everyone agrees that these outcomes must be achieved. The debating point is whether we need to do more. It is my view, based on experience as a trade negotiator and businessman that there are other countries in the world who do more and we would do best to follow their lead.

Japan, Germany, Singapore, Korea, and other nations not only purse the basic noncontroversial growth-oriented fundamentals, but also integrate their technology, industrial, and trade policies with these broader macroeconomics policies. They do so because they recognize that their aggregate economy is made up of pieces, and that the health of these pieces is important to the health of the overall economy. For example, they realize that in order for tax policy to be effective, there have to be companies that are earning enough money to pay taxes. Or, that their national firms may need to export in order to achieve economies of scale to be profitable.

What these nations share is the view that the structure of the economy is an important factor and determinant of the overall productivity of the economy. There-

fore, what the economy produces is important and by extension, what it trades is important. More importantly, their success suggests that it is a matter of priority to understand linkages in the economy and their impact on the structure of the economy.

We must understand the impact of our various regulatory, defense, and other economic policies on the structure of the economy. We must understand that the effects of our trade and technology policy will be felt throughout the economy.

U.S. policy making often has been negligent because we have been led by people who embrace a notion, captured in a quip from former Bush administration economic advisers: "Potato chips, computer chips, what's the difference? They're all chips." Implicit in this statement is the belief that it does not matter what we make. As a result, our trade policy has focused on obtaining something called free trade by addressing processes, rules, and procedures. Meanwhile, the content of our trade and the structure of that trade was deemed to be unimportant since it was believed that the natural resource endowment of nations would lead to the production of what is best for each nation's particular circumstances.

In a similar vein, technology policy was driven largely by defense needs, and we eschewed a broader industrial policy that would link technology policy with trade. The reason was concern that excessive government interference would result in "picking winners and losers" in the civilian sector. Our fundamental, national view was that structure doesn't count—what we make doesn't matter. High technology industries or low technology industries, the mix was unimportant. As a result, we have tended not to respond to the industrial policies of other countries that targeted the industries of tomorrow. Traditional, neoclassical economists argued that these nations were only hurting themselves. Subsidizing Airbus, targeting the supercomputer industry, or dumping in our market was simply a gift to our consumers—if it wiped out American industries, not to worry because our economy was growing, creating new jobs and people could always find work.

But, if you accept that structure counts, that what we make does matter—then it is necessary to form coherent technology, trade, and industrial policies commensurate with our goals and integrate these policies with the rest of our macroeconomic tools.

PAST TRADE POLICY

Since the end of World War II, we have championed the cause of free trade and open markets, and have pushed for liberalization of world markets by focusing on the procedures, rules, and processes governing international commerce. Our overriding concern, however, was geopolitical issues, and as a result, trade always took the backseat In effect, our economic doctrine defined U.S. welfare as being identical to that of the entire world economy. Typically, there was little concern for trade deficits since the standard argument was that trade deficits are a function of savings, investment, and government spending. Since trade deficits, or more precisely, current account deficits, lead to devaluation and indebtedness, it has become necessary even for the most blase to admit that, at some point, trade deficits are significant.

Usually, the trade deficit is attributed to a lack of domestic savings and the cure prescribed is an increased savings rate and a reduction of government spending. Underlying this is the classic view that net exports are the result of savings, investment, and government spending behavior. The well-known accounting identity is "Savings-Investment+Budget Surplus=Trade Balance." The conventional explanation of this identity is that nations with a high private saving rates and budget surplus or small budget deficit will likely run a trade surplus. At the same time, a nation with a low savings rate and a large budget deficit will run a trade deficit While this is true as far as it goes, it is not the only interpretation of the accounting identity. Since this is an equilibrium equation, it is as possible for action to operate from right to left as from left to right As Harvard economist and former Undersecretary of State Richard Cooper has written, "this accounting identity says nothing about the dynamics of the impact of policy actions on the economy." Recent econometric work by Dr. Robert Blecker shows that savings, investment, and government surpluses and deficits also are affected by net exports, and not simply vice-versa. This cutting edge economic work indicates that a significant portion of the U.S. trade deficit is structural in nature and that at least some of the drop in U.S. savings rates is caused by structural barriers and practices that contribute to the U.S. trade deficit. That the action in the identity can be both ways is confirmed by the conventional remedy to trade deficits-currency devaluation. It is by acting on the net export side of the equation that the remedy aims to change the equation's terms. To make the point in another way, suppose that tomorrow the Japanese government

removed all barriers to procurement of supercomputers. The result—U.S. sales by firms such as Cray would increase, firms would realize lower costs and achieve higher profits, and U.S. net exports would increase. Part of this would be turned into savings, taxes, and debt reduction.

Thus, it is clear that we should not rely only on the traditional macroeconomic tools to reduce trade deficits. A structural trade deficit will not readily respond to a currency devaluation. If we devalue our currency to overcome such a problem, we will wind up hurting ourselves and not reducing the trade deficit by much. Of course, there is an exchange rate at which imports become prohibitive. If we went to 50 yen to the dollar tomorrow, we wouldn't buy anything from Japan. But that is really impoverishing ourselves.

Structural issues must be resolved with structural means—not macroeconomic tools. This is not to say that exchange rates or other macroeconomic tools are unimportant. Exchange rates are important and it is vital to have the right exchange rate, however, it's not the only tool. We must solve our trade problems with the appropriate measures. This means, in part, weaning ourselves from the tendency to use exchange rates and macroeconomic tools to solve problems that they cannot.

It is difficult to disentangle the impact of all the factors that contribute to the trade deficit, but there are some indicators of the possible size of the U.S. structural trade deficit with Japan. In the wake of the halving of the value of the dollar in the latter half of the 1980s at the Plaza Accords, the U.S. trade balance with Europe swung from a deficit of roughly $20 billion to a surplus of the same magnitude. In the case of Japan with which the United States has about the same amount of trade, the U.S. deficit dropped only from $59 billion to about $40 billion. The U.S. deficit with Japan is back in the $50 billion range and this suggests that there is a strong structural element in the U.S. Japan trade.

A structural trade deficit is one that does not respond readily to exchange rate changes because it arises not from macroeconomic causes but rather from such factors as formal trade barriers, varying regulatory regimes, and informally restrictive business practices. It is not unfair for other countries to have a different view of industrial or antitrust policies which result in a range of structures from foreign cartels, keirestu and chaeboi in Japan and Korea, to controlled distribution. These institutions are not necessarily unfair as our current trade laws characterizes them. Yet, these differences often put us at a disadvantage because our manufacturers are unable to achieve the same economies of scale as other manufacturers. The long-term solution to the problem is to somehow harmonize these structural asymmetries. This naturally leads to managed trade or results oriented trade. Most people automatically assume that trade management means negotiating specific market shares or cartelizing a market, but this is not so. For years we have engaged in managed trade without negotiating market share. International airline routes, for example, have been decided on a bilateral, reciprocal basis where the number of flights, landing rights, and cabotage issues are negotiated and, in fact, market share fluctuates significantly. This management occurs because we understand that if we simply opened our market to foreign airlines which are often run and subsidized by their foreign governments, our carriers would be overrun. Instead, we manage airline travel to achieve equivalent competitive-conditions that ensures competition among countries with structural asymmetries.

For another example, take stock markets. Both the Tokyo Stock Exchange (TSE) and the New York Stock Exchange (NYSE) are markets where businesses raise capital, but the structural assymetries between these two markets gives rise to wholly different outcomes. There is nothing wrong in these differences—but, they can cause serious competitive disadvantage. If the parameters governing the NYSE were somehow altered to reflect and mirror those of the TSE, the outcome would change drastically. One of the most obvious effects is that small and medium sized firms would be crushed because the TSE operating conditions favor large firms.

IMPORTANCE OF TRADE

Most of the discussion of our trade problem is in terms of the size of the trade deficit It is often argued that the size of the trade deficit is a function of the budget deficit and therefore not changeable. But this premise is false. Trade friction arises more from the composition of the trade deficit than from its size. Consider that we have had a large trade deficit with Saudi Arabia for a long time and virtually no trade friction. We have a trade surplus with Europe, and yet we have lots of trade friction. Theoretically, we could balance trade with Japan by shipping enough logs, scrap aluminum, waste paper and Alaskan crude oil to balance out the Toyotas, copiers, VCRs, etc. that we import from Japan. But would that really solve our trade problem? I think not.

The reason is that the trade friction arises as a result of the displacement of key U.S. industries by foreign industries. The friction is particularly virulent when this displacement takes place under conditions that seem to be inequitable. We are concerned about the displacement of such key industries because it has important affects on U.S. productivity, technology development capability, and national security. Thus, even if the size of a trade imbalance is largely due to macro-economic factors, or even if we have an overall trade surplus with a particular country, there are still important grounds for concern about bilateral trade on a sectoral basis.

The principle involved here is the trade analog of the familiar potato chips-computer chips dichotomy. If what we make matters, then what we trade also matters. Our trade analysis and policy should, perhaps, be less focused on overall deficits and surpluses and more on industry-by-industry trade dynamics.

There are essentially three categories of trade. The first is traditional Ricardian, factor endowment based trade. The United States imports bananas from Costa Rica which has a warm wet climate and exports douglas fir from the cold wet Pacific Northwest to Costa Rica We can't grow bananas and they can't grow douglas fir or at least not at any acceptable cost, and so we trade and both sides are better off. This trade takes place more or less spontaneously and the rules of the GAIT are perfectly adequate to regulate it Deviations such as the U.S. sugar, peanut, and beef quotas are costly and reprehensible.

The second category of trade is government to government transactions. The best example is military sales and military co-production and licensing arrangements. This trade is totally managed with offset, technology sharing, and domestic content requirements. The principles of free trade have nothing to do with these kinds of arrangements and the United States should never kid itself that they do. The problem of the United States in the past in this category has been that it has usually subordinated the economic aspects of the deals to the achievement of geo-political objectives. In the case of the FSX, for example, the U.S. objective was commonality of equipment and smooth relations with the Japanese air self defense forces, while the Japanese objective was acquisition of U.S. aircraft technology at the lowest possible cost The guiding principle for U.S. negotiators here should be to get as much as we give in purely economic and technological terms without regard to the diplomatic and political questions. In short, we should recognize that this is always going to be managed trade and attempt to manage it to maximize our own economic advantage.

The third category is that of goods in which comparative advantage arises not from nature but as a result of humanly arranged circumstances. It is here, of course, that most of the controversies arise.

FUTURE TRADE POLICY

An appropriate model for trade management might be the affirmative action deregulation of the telecommunication industry. In America, because of the past history of the industry and its consequent structure, it was clear that one could not simply remove regulations and tell AT&T's challengers that they could compete: AT&T assuredly would have crushed any newcomer. Certain restrictions were therefore put on AT&T in order to give a degree of affirmative action and a significant market share to MCI, Sprint, and others. By managing competition in telecommunications for a time, the government was able to change the structure of the market and make it more competitive.

Another case where trade management could create equivalent competitive conditions is in auto trade between the United States and Japan. In the United States, the same dealer may sell Ford and Nissan or Chevrolet and Toyota In Japan, auto distribution is tightly controlled by manufacturers which means that to sell in Japan, a U.S. company must set up an entirely new dealership network which is both time consuming and costly. Because markets with such closed dealer systems are more difficult to penetrate than the U.S. market, the American auto industry is at a long-term disadvantage. Not being able to increase sales in Japan means the American auto makers have a lower capacity utilization rate, and are less able than their Japanese competitors to capitalize on economies of scale. The result is that even if American quality and productivity are perfect, the U.S. industry will be less able to sell in the world's major markets than its Japanese competitors who will have lower costs.

A solution would be to negotiate a deal such that either all Japanese dealerships are open or all American dealerships are closed. Or, we could compromise at 50-50 with half the dealerships in each country open and half closed. This is only a theoretical solution to the problem. The basic objective of U.S. policy makers should be

to achieve conditions such that U.S. industry is not forced to compete at a disadvantage.

Of course, the objective of our trade policy should be to increase trade. The trend of technology and the scale of production needed for global market success guarantees the shrinkage of time and distance inevitably leading to the integration of world markets. But, the terms "globalization," "borderless economy," "mutual interdependence," "internationalization," and the like should not be used as excuses to avoid thinking about the consequences of such interdependence. In a world in which what is made matters, the precise terms of interdependence are very important Typically, we have not worried about trade issues because of the belief that all markets will be integrated and all multinational corporations act the same. But they don't.

A brief historical glance highlights the point that the terms of integration are crucial to the relationship between the affected countries and indeed, the world. India and England were integrated and interdependent, but India was dissatisfied with simply shipping raw materials to England for processing. The United States and Great Britain had similar problems several hundred years ago. The terms of the integration of different economies are very important, and trade policy is one component that deals with the terms of integration. So, while we should strive for liberalizing trade, we don't want to do this unilaterally. While we want free trade we don't want simply to engage in laissez-faire trade. We must liberalize trade on the basis of equivalent competitive conditions. To do this we need to use all our tools, macroeconomic tools like exchange rates and where necessary structural negotiations such as affirmative action to equalize the competitive environment in order to achieve favorable terms of integration.

INTEGRATION OF TRADE AND TECHNOLOGY POLICIES—INDUSTRIAL POLICY

Typically, industrial policy is described as picking winners and losers or subsidizing industries. What is missed in this caricature of industrial policy is that every country has an industrial policy, conscious or not. All policies affect both the structure of our economy and the health of sectors of the economy either negatively or positively. When choices are made over the allocation of the telecommunication spectrum, when the Defense Department spends money on new R&D, when agendas for trade negotiations are decided, when capital gains taxes are introduced, or tax write-offs on mortgage payments are enacted-industrial policy is at work. Typically, we have pursued these policies independently without thinking about their effect on the overall productivity of the economy. At the moment, in lieu of any overall guiding criteria, the choices we make are inevitably the victim of politics or happenstance. For example, the break-up of AT&T was an industrial policy, yet, we didn't analyze the break-up from the point of view of its productivity impact. Instead, it was viewed simply as an anti-trust case. Why has rice been such an important part of our trade agenda with Japan? Certainly not because analysis shows major economic gains from opening Japan's rice market The way that we impose environmental regulations, work rule regulations, the choices we make in trade negotiations, or how we exercise our anti-trust legislation have a huge impact on long term productivity and should be analyzed from this perspective. That's industrial policy.

Industrial policy is not simply a matter of subsidizing industries. Boeing doesn't need subsidies, it's the world leader in the aircraft industry. What is needed is to respond to the attacks on our competitive industrial position by other governments, such as the Koreans, the Japanese, or the Europeans who have explicit policies aimed at beating Boeing, Douglas, Cray, and our other companies.

The future of Cray and our other manufacturers of high technology goods is integrally related with our trade policies. As the Office of Technology Assessment reported to Congress in 1991, due to the protection of the supercomputer market in Japan, Cray and others lost more than $700 million of sales. Moreover, to produce super computers requires very large investment in R&D as well as in plant and equipment If Cray and others are able to amortize that investment over only two instead of all three of the world's major markets, its costs will be higher than necessary, its ability to invest in new research and new plants will be less, as will the number of people it can employ and the wages it Ban afford to pay. Ensuring the health of these companies means having an active, trade policy that achieves measurable results.

Industrial policy means understanding that having leadership positions in critical industries is important and that we must respond to the industrial policies of other nations in an appropriate fashion. Industrial policy means recognizing that industry swims in a pool and that the temperature and viscosity of the water is determined by the actions of government To ensure that if you have Olympic swimmers they

can go fast, there needs to be close cooperation between government and business. Even the greatest Olympic swimmers in the world won't go very fast if you put them in wet cement.

In the final analysis, the United States cannot hope to confront the new era of geoeconomics successfully if, as a matter of highest priority, it does not revitalize its domestic economy. It must concentrate on building and maintaining leadership in industry and technology through a comprehensive economic strategy. U.S. international economic policy must be an extension and integral part of that strategy; that policy should focus on stimulating world economic integration, a favorable trade composition, as well as broad reciprocity and affirmative action in key trading relations. To do this, Americans will have to abandon much of the conventional economic wisdom that has misguided U.S. policy for years.

Senator KERRY. Thank you, both of you. You have done exactly what we knew you would do and what you have done previously at other hearings, which is help to really focus this issue.

Let me just ask you, if I may, as a beginning place, about the playing field, because one of the purposes of this hearing is to try to understand it. And I am not sure that it is as much a difficulty in defining it as it is in getting people to wake up and acknowledge it or recognize it. It seems to me that for a period of time in this country we saw the same thing happening to ourselves internally.

Fritz Hollings in South Carolina was terrific at getting the jobs from Massachusetts. And for a period of time, certainly through the 1800's, most of our trade history in the United States was this struggle as we worked out problems of valuation and rules of the game. We created institutions to order that such as the ICC, our Supreme Court has ruled, and we have ways of working this out within our domestic law.

For a while that worked internationally through GATT and through the original agreements of Bretton Woods. The question is now—and I think you have both partially answered it, but I want to really focus on it and perhaps drive it home—are we not in a different world internationally where we have not paid attention to what we learned about our own sort of structure for organizing trade?

We do not have rules that apply to the current situation. And we are sitting there basically pretending, as you said, that they are going to convert to Christianity, when, in fact, there is nothing that is compelling them to, interesting them in it, or even adequately or sufficiently educating them about it. So, would you agree that we are just off target in terms of the structure that we are willing to live with with respect to what is supposed to order the international engagement?

Mr. PRESTOWITZ. I would agree with that. I would argue that I do not think countries, for the most part—let me modify that and say I think many countries have never played by the rules. The reason it has come more to our attention recently is because in the first 20, 25 years after the end of the Second World War it was not so apparent that they were not playing by the rules because we were so dominant that it did not matter so much to us.

As our dominance has diminished and our ability to compete has diminished, we have become more conscious of the rules and whether they are being adhered to or not, and of course, it becomes more of an issue. But in fact, I think they have never played by the rules and I think this is part of the problem. We acquiesced for a very long time in an asymmetrical situation in which we more

or less unilaterally engaged in market opening and made economic concessions without requiring reciprocity. And so it has become part of the warp and woof of the system.

I had breakfast this morning with the ambassador of one of our leading trading partners in Asia. And I was fascinated to listen to him talk, because he was talking about the problem of rising protectionism in the United States and how terrible that was. And I then asked him how many U.S. autos were sold in his country last year. And of course, virtually none. And then I asked him well, "Why is that?" And he said, "Well, you know, Confucian society, our people do not go in for ostentatious consumption" and so forth.

I mean, the point I am trying to make is that this fellow who thinks of himself as being an adherent of free trade has a mental concept of the way the world works in which it is taken for granted that the U.S. market will be more or less open and that any deviation from that is evil protectionism. While at the same time, markets elsewhere in the world, in Asia, for example, will be much more closed, but that is just the way the game is played. And this is part of the warp and woof of this system.

I think it was really explained well by a guy named Mau Hiroamaya, former MITI Vice Minister in Japan. He likened this situation to a game of golf. He said, you know, "If you and I play with Jack Nicholas, we get a handicap. We do not play under scratch rules. And if we play a lot maybe we get better and then the handicap is adjusted."

Well, he pointed out that the end of the Second World War the United States gave everyone a handicap. The problem is that the other countries have been practicing and they have gotten very good, but there is no independent handicapper except the United States. And when we try to change the handicap we then get accused of being protectionists and bashers and so forth.

Senator KERRY. Dr. Thurow, did you want to comment?

Dr. THUROW. I think the world is changing in the way that I mentioned from the old world of comparative advantage into my world of manmade comparative advantage. But I really believe that the GATT/Bretton Woods system—I think you used the phrase it has come to the end of the line. The problem is that was built for a world where the United States was 50 percent of the world GNP and it was an American-dominated world.

We are now something like 23 percent of the world GNP, and it is not an American-dominated world. And I think that means two things: One, there are places, like a value-added tax, let us say the antitrust laws, where we have to adjust our practices to the common practices in the rest of the world. You know, if you think about business groups, it is not that the Japanese are off the standard trend line with a business group, it is that we are off the standard trend line because we are one of the few countries that prohibits those kind of business groups.

And so I think it is partly us adjusting to them, but I think it is also partly being willing to design a trading system which recognizes that people are going to have different internal practices in their countries, as Clyde said, and we are still going to trade with them, but we have to do it in a more complicated way than if you said everybody was going to organize their economy exactly like the

United States, and we are going to make it a deal like competing like South Carolina and Massachusetts. It is not South Carolina and Massachusetts, for a whole variety of reasons.

Senator KERRY. We agree, then, that the GATT structure simply does not address the concerns that we have today. Is that not fair?

Dr. THUROW. Nobody thought about these issues like Confucian values or kieratsus or industrial policies at the time the GATT was set up. Nobody in their wildest dreams thought of it.

Senator KERRY. Assuming that we are in agreement on that, then, do we have the leverage at this point, do we have the capacity without resorting to a "fight fire with fire" approach, to bring people to the table? I mean, we have had trouble obviously closing out the GATT. We have resolved the agricultural differences, but this round is clearly troubled. How do we go about that? Can we leverage a finality to it?

Mr. PRESTOWITZ. Well, yeah. I think you can bring the Uruguay Round to a close.

Senator KERRY. But that does not get you where you need to go.

Mr. PRESTOWITZ. But that does not get you where you need to go. And I think that in fact I would argue part of bringing the Uruguay Round to a close, and to address one of the points that Senator Rockefeller made earlier, I just got back from Geneva on Sunday where I met I met with a number of the Uruguay Round Ambassadors and something is shaping up which I think is very troubling.

The single most pressing demand objective of virtually all of the people with whom I met, and I met with a great variety from Asia and Europe, was an end to, "U.S. unilateralism," which means the application of the Dunkel text in a way that would reduce U.S. abilities to use 301 and the antidumping law. And I told each of them that that, of course, is the single issue on which this thing could fall apart in the United States. I see that shaping up as a real clash.

One way to address that would be to make conclusion of the Uruguay Round conditional upon further measures that would, in fact, deal with issues like industrial policy and Keiratsu and some of these more structural, more cultural issues. But it is clear then, if you simply conclude the round on the basis of the current Dunkel text or even a modified text, it does not really address the most pressing issues in the trade system. It does not mean that it is useless. I mean, a successful end to the Round would be a nice thing to do.

Senator KERRY. Well, that takes you right to the point of confrontation that I am addressing. I mean, if their current problem is the 301 and perception of unilateralism, and yet we are perceiving that in order to get people to the table we need to engage in that way, where does that take you? Again, I come to the question of what is the leverage to bring about cloture with respect to the larger issues that are not currently contained in the Dunkel draft?

Mr. PRESTOWITZ. Well, the problem is there is not a lot of leverage room and the leverage ultimately comes down to access to the U.S. market. Or let me say this in a somewhat different way. Actually, the United States is still a very powerful country. And we provide a lot of things. Most of the technology flow in the world is

largely out of the United States. MIT, for example is a place that foreign scientists and engineers and students flock to. NIH is a place that foreign researchers flock to.

This conversation I had with this Asian Ambassador this morning, we were talking about security in Asia. And the question arose, well, in a postcold war world, what is the role of the American military in Asia? And it is very clear. The role of the American military in Asia is to protect the Asians from themselves. We provide stability. Our presence there tamps down what otherwise might be very dangerous conflicts between some of the Asian countries.

And actually, the funny thing is that we are in a situation in which—let us say in Asia—we are providing the stability that makes, that underpins this dynamic economic growth. Yet at the same time, I have been attending meetings recently in which I have been told by Asian leaders that the United States has to be sure to—because Asia is growing so fast economically the United States has to be sure to accommodate Asia, that it would be dangerous for us not to be able to participate in the Asian markets, and therefore we have to be wary about how we proceed with our trade laws, because that could lead to retaliation against us. And somehow, it seems to me the tail and the dog are at the wrong end here. So, we have leverage, in a very broad sense, and of course, this market remains the biggest market.

There is an article in one of the magazines I was looking at yesterday which said the Asians now trade a great deal among themselves. And of course that is true, they do. But China does not have a huge trade surplus with Japan or with Indonesia or Korea. But it has a huge trade surplus with us. And so very broadly speaking, I think we have a lot of leverage.

Let us take the trade deficit with Japan. Chairman Volcker pointed out the U.S. auto industry is quite competitive. In fact, our institute has done some analysis which indicates that Ford and Chrysler are the low-cost producers right now, lower cost than Toyota or Nissan or Honda. Now, the Japanese companies all have plants here making cars. Those cars, despite the fact that the United States is the low-cost producer of parts and materials, the Japanese autos have a very high percentage of Japanese content, in most cases over 50 percent.

This has to do with keiretsu, with long-term relationships, and what have you. But all of them are on record as having said publicly that they want to reach 80 percent U.S. content. All of them are on record publicly as having said they are going to export cars from the United States back to Japan. As far as I know, no President of the United States, no Secretary of Commerce, no U.S. Trade Representative has even so much as picked up the telephone and called the president of Honda or Toyota or Nissan USA to ask them how to do it.

I think that if a President, if you, you Congressmen, you Senators, if you called up the presidents of Honda U.S., Toyota U.S., Nissan-Mitsubishi U.S., and you said "You know, I have been reading these press clippings that you have put out over the years about your objectives, high U.S. content, you want to export cars back to Japan, you want to make a positive contribution to the U.S.

economy. How do you do it? When are you going to hit 80 percent? You have been here 10 years now. When are you going to do it?"

If Ron Brown and Mickey Kantor would call them up, if the Commerce Department would just publish periodically their estimates of North American content in some of these areas, this would build tremendous peer pressure and give us great leverage, and I just use that as an example. I mean, I am not trying to pick on Japan or the auto industry. The Japanese—this is the biggest market in the world for videotape recorders. Not a single one is built here. And the same could be said for other countries and other products.

So, yes, I think we have a lot of leverage, and I think much of it has to do with our attitudes, with letting other people know that we are serious. I mean, if you ever get a call from the President of the United States about some of these problems you could be excused for thinking well, he is not serious.

Dr. THUROW. For the 30 years after World War II, we had a geopolitical strategy and we would occasionally use some economic chips to increase that geopolitical military strategy. We never had a geoeconomic strategy.

The problem now of course is we do we use some of our geopolitical chips, like the American Army is in Asia to help us in our geoeconomic strategy. But we do not have a geoeconomic strategy. And if we look at the institutions in Washington, we do not even have a place to formulate it.

Because if I want to know what is the American military geomilitary strategy, I know where in Washington to get an answer. If I want to know what is the American economic strategy vis-a-vis the rest of the world, a little here, a little there, and there is no place to go and get the answer.

And so I think the biggest change is changing our own concept of what we are about in the rest of the world. And this goes back to the end of the cold war. We do not, you know, really have geopolitical military aims the way we had when the Soviet Union still existed. But we should be having some geoeconomic aims and how do we get them organized and implemented and how do we carry them out?

And I think that is a big job, since we have not done it for 50 years.

Senator KERRY. Well, let me just turn to my chairman and my other colleagues and comment as I do that I agree with your definition of the "leverage." I think also the leverage may be for us to think differently about antitrust laws and other aspects of how we have been doing business here at home in order to send a message that we are not going to just sit here like patsies and allow each of these industries to be cherry picked away; but we are, in a sense, going to fight fire with fire until they say, "Hey wait a minute, that is not so good. We really ought to sit at the table and work out an agreeable process with dispute resolution."

Now some of these things may be difficult on the GATT, but on the other hand we all know that the resolution process under GATT is not satisfactory. And so to whatever degree others are willing to push the envelope, it occurs to me that we also ought to push the envelope in order to underscore the notion that if we are going to operate in this world, we have got to come to the table and

have agreement and live by it and not just watch our jobs trickle away.

Senator Hollings.

The CHAIRMAN. There is so much to be said. Right to the point, Mr. Prestowitz, most respectfully, having the USTR calling the president of Honda would be the weekend joke at the Honda plant.

It is not that. Heaven's above, I was in the fish room, they call it, in the White House, with President Kennedy. And they had the Japanese there and we were going to be serious and everything else of that kind, 30 some years ago. And then you have President Bush running over there hollering, "Please buy automobile parts."

That hasn't made any impression on them. They have got a semiconductor agreement that is really only adhered to as the result of the recession over there. They are not going along with that.

You have got to be realistic and let market forces operate, and you folks made a very, very valuable contribution by instructing that the government is a fundamental part of the market. There is no doubt about it.

And so I go right to the hearing that we had previously with the Big Three, Chrysler, Ford, General Motors. And the statistics were brought up that the Japanese earned more than $9 billion in their home market while losing over $3 billion in North America and another $1.4 billion in Europe.

And the Toyota Cressida that sells this minute in downtown Washington, D.C. for $23,500, sells for $31,500 in Tokyo right this minute. And you know what, the Big Three will not bring a dumping case. The vote was two to one.

Now I am trying to bring pressure, not for rhetoric or telephone calls, just to get the blooming Secretary of Commerce under the law to bring a dumping case. You can prove it categorically very easily.

And that is the tremendous frustration. We have got all of these laws on the books. We never enforce them. And I think that is the first order of business, not calls on the telephone.

Dr. Thurow, let me comment on your theory that the United States simultaneously boosts a first world and a Third World economy. One-third of the labor force has first world skills and will be paid a first world wage, but two-thirds of the labor force has Third World skills.

I might suggest an amendment to that. And that is, when you said further that rates of return and wages are not identical, you might also add the change that skills are not lacking, jobs are.

I will never forget 30 some years ago when we had J.P. Stevens and Col. Bob Stevens was not only head of J.P. Stevens at the time, but on the General Electric board. And we brought in the gas turbine facility of General Electric there in Greenville, S.C., which is prospering by the way.

The Wall Street Journal, the day of the announcement, said that there was a lack of skills, a lack of jobs, labor. And they wanted to know where they were going to get the labor to make the gas turbines. And I could see Secretary Stevens stumbling, and I just got up and said, "They are going to leave Stevens Textiles and go to Stevens turbines."

Right this minute, we do not make automobiles in South Carolina. And BMW had not come to us because we have automobile skills, but because we can produce those skills like gang busters over night.

We have got BMW and others coming to South Carolina, because we have got the technical training facilities. I find that almost a ritual with our friends in the economic world, always saying that what we need is retraining, retraining, retraining, more skills. I have got skills coming out of my ears.

And incidentally I got the technical training program from Ohio and Connecticut. Abe Ribicoff and Mike Disalles helped me set it up. So, I got it from the northern States. And we have got the skills. We just do not have the jobs. And that is really the problem.

Dr. Thurow, Dr. Prestowitz—either one—can comment, since you brought up the observation, both of you, that we need the Government, whereas for the past 12 years we have heard that the Government is the enemy. Get rid of the Government. The Government is not the solution. The Government is the problem.

At least your appearance will help us dispatch that foolishness. I have tried to analyze really what happened. Yes, we were fat, rich, and happy, and very properly with the Marshall plan taxed ourselves, sent over not only the jobs, the money and so forth, but sent over the skills, sent over the expertise. And we just developed the Pacific Rim and Europe and by the way, capitalism has prevailed and it has been a tremendous success.

There is no criticism of it. But the banks, in financing this endeavor, then found out that they could finance these operations to bring back these products into the country. Forty-one percent of what we import into the United States right now is American multinational generated.

The nationals became multinationals. The American banks buddied up with the multinationals, organized the Trilateral Commission and all of the rest of those think tanks. The think tanks got into it. And, "free trade, free trade." All you have to do is run for President and the first thing they do is invite you to make you swear almighty faith on the altar of almighty free trade.

Thereupon, the retailers got into it. When we debate a trade measure, we go down to Hermann's and we get two catching gloves, one made in Detroit and one made in Korea and they are both $42. The retailers are not selling the import for less. They are making a bigger markup.

Similarly, in Bloomingdale's, a ladies blouse made in New Jersey, and one made in Taiwan, $32 apiece. I put in the record some few years ago the year-end statement of the Washington Post. And they made $1 billion from advertising.

Eighty percent of it or $800 million was in retail advertising. So, the retailers get on the newspapers and they sport these editorials that they get from these think tanks. Free trade, free trade, free trade.

And then of course all of us here in the Congress are candidates for President. And so we want to act like we are erudite and we see the light and all that kind of stuff and nonsense.

What we really have to do is analyze this thing, because we almost need you two to start a 40-hour course of instruction for Congressmen and Senators in reality.

Milliken is in textiles. They won the Baldridge Award. Again, it is not a Third World skill. It is highly skilled. They have got down there Milliken University, and they require 40 hours of training. And they study, incidentally, the Japanese and their competitive system and what they are doing 5 years ahead.

Our industry is awfully competitive. What has not competed or produced is right here, the vacuum that the distinguished chairman referred to as right here, in Washington. Or we could use the word "stupid." We do not pay our bills, we do not put in a consumption tax, and we do not enforce our laws.

What really hurts now is how do I get down to the latter part of Dr. Thurow's analogy and see what we need to do is get, instead of a loser-driven industrial trade policy, a competitive trade policy, when the crowd around here does not even believe in the Government?

I think maybe we ought to go to the top of your page where you said that in the class at MIT, you could show some wonderful technologies. Some will lead to big important industries and some will not.

We did something similar in this committee over in the Commerce Department under article I, section 8 which says that the Congress shall regulate foreign commerce.

And in the Commerce Department we had this wonderful entity, the Bureau of Standards. We reformed it into the National Institute of Standards and Technology. We then put in regional research centers, emulating the land-grant college approach, the Advanced Technology Program. And we let industry come in and make their suggestions and with peer review, not the Government selecting what is important, to decide what those particular technologies or other entities are that can or should be developed.

When it just comes to an up-and-down vote, you are not going to get a trade policy. I think we would get a competitive trade policy if we started enforcing the laws. And that is what we hope to do.

But otherwise, how do I get here to start picking these things out other than on an emergency basis? We did it with Sematech, and now the semiconductor industry has become revived in America.

Dr. THUROW. I want to back you up on something you said. And that is, skills are only one-half the problem. The other one-half of the problem, where are you generating the high-wage jobs that are going to use those skills?

And let me pick up on one of the things that Clyde mentioned. The second biggest industry in the United States and in the world, after automobiles, is consumer electronics. That is an industry that, for all practical purposes, has no American presence. It is highly unlikely that a country as big as the United States is ever going to be able to offer most of its citizens a good job without a consumer electronics industry. It is not going to happen.

We have a technical opportunity at the moment. Consumer electronics is all shifting from analog technologies to digital tech-

nologies. American companies and American research centers are still the world's leaders on digital technologies.

So, we do not have to go out and out compete with the Japanese building the analog consumer products that they built in the past. The question is, How do we get organized to jump in on these new things that are coming down the pike? The problem is it just is not going to just happen automatically in the market.

Because this is not something that Steve Jobs can do in his backyard with $50,000, if for no other reason you have got to have a brand name. It takes $500 million in the United States to establish a brand name, $200 million a year to protect it, in terms of advertising, before you do all the other things.

And I do not know what the answer here is as to exactly how we do it, but somewhere in the United States we should be focusing on the problem. Government, industry, research centers like MIT, how do we get back into consumer electronics and start generating some good American jobs for Massachusetts, West Virginia, South Carolina in this second biggest of all industries?

And it is that kind of question you have to be able—you have to ask.

The CHAIRMAN. Well, the answer to that question would be in our bill to create a national trade council. Harry Truman said, I cannot get this intelligence and defense and State Department and everything together, so by Executive order he said, "Now, you all get together in the White House and come up here with a couple of alternatives and I will make a decision."

And out of it you got the Marshall plan, the Truman Doctrine, the North Atlantic Treaty Organization, the visionary foreign policy. So, we for years said, "let us get a National Trade or National Economic Council. Now we have got the National Economic Council, but we are in the hands of the Philistines. They are talking about free trade instead."

I keep hammering on them. But that would be a wonderful entity to correlate the Department of Commerce, special trade representatives, Department of State, Defense, and everything else.

Is there any way to beef up that National Economic Council or something and get it into trade, competitive trade, Mr. Prestowitz?

Mr. PRESTOWITZ. I have a thought on it, a couple of things. One is that if I want to get a diagram of the structure of the U.S. economy I can get it. And the place I can get it is MITI in Japan. I cannot get it from any entity of the U.S. Government.

The administration is preparing to go into an extended negotiation with the Japanese on what they call a "new framework of negotiation." And I have applauded Ambassador Kantor and others in the administration for moving in that direction. But I do have a concern. And that is how do we know what it is that we want to negotiate with Japan when we really do not have the capacity—we have not used the capacity in our Government—to analyze the structure of our economy and the structure of their economy to know really where we are very competitive and where they are competitive.

Now, actually we have in the Government a series of industry sector advisory committees. We have the President's Export Council. And we now have the National Economic Council. Japan has

a thing called the Industrial Structure Council. And it has such an importance in Japan that I remember back in the mid-eighties when some of us tried to persuade the Japanese to include representatives of foreign companies in Japan on their Industrial Structure Council. The response came back to us that when we put Japanese on our National Security Council they would consider putting representatives, even Japanese citizens, representatives of American companies on the Industrial Structure Council.

So, it is a central place in Japan where industry representatives, government, academic representatives, they even have media people on the council, meet and systematically analyze the content and the structure of the Japanese economy, and think about where it is going and what the high value-added industries are going to be, where the jobs are going to come from, what skills will fit those jobs, and what policies are needed to support and promote movement in that direction.

We do not have that, but it should not be so difficult to do. If you took the existing NEC and the sectoral advisory committees and the President's Export Council, you already have, incipiently, the core of that kind of a capability. And I would urge that some thought be given to merging those and creating this kind of a structural capability. And I would even say that, you know, it is something which could be done in the executive branch of the Government. But if there were resistance there, there is nothing to stop the Congress from setting up its own industrial structure council.

The CHAIRMAN. Well, maybe we will have to do it. But you can see, even as Ambassador Kantor moves and tries to get realistic enforcement of our trade practices, dumping and otherwise, all the editorial writers are jumping all over him. They do not know what the trade policy is. I agree, it is a loser-driven trade policy. I have always called it an appeasement trade policy. And we could afford it at the end of World War II. We were fat, rich, and happy. But we are not fat, and we are not rich, and we are not happy any more.

Let me yield at this point. I do appreciate this. I think you folks are going to be requested to testify again. I do not want to wear you out, but, time and again, these are very, very important hearings, and you really bring in a studied approach on free trade. Like world peace, peace, everywhere men cry peace; the best way to preserve it is to prepare for defense. And similarly, we are all for free trade—how do you get it? Get competitive.

Take a lesson from old Roosevelt in the days of the Depression. In order to keep the banks open, he closed the doors. In order to save the farms, he plowed under the crops. In order to remove a barrier, we need to raise a barrier and remove them both, and the market forces there will operate.

Thank you, Mr. Chairman.

Senator KERRY. Thank you very much, Mr. Chairman.

Senator Rockefeller.

Senator ROCKEFELLER. Chairman Kerry, this has worked out to my disadvantage. I am seeing the Spanish Minister of Trade on the Dunkel draft at 12 noon, which gives me 3 minutes to ask a question, and I might as well just make it a formal one.

Reich, in his writings, talks about who is us. And that is a question of globalization of manufacturing. Who is American, the U.S.-owned company that makes all its products in Mexico and Singapore, or the French-owned company that makes its product here in the United States?

Reich suggests, as he says, "that 'usness' is defined by where jobs are." If there are in the United States, then you should consider them to be an American for policy, American jobs for policy purposes.

What I would like to ask each of you briefly is to comment on whether that is the only factor. It seems to me that who controls the profits and the technology also matters, because they will determine where the research and development then takes place and where future, therefore, high-skill, high-wage jobs are likely to be.

Now, there is no certainty that Americans will make more "pro-American manufacturing decisions than other countries will." Because our companies wander the globe as well as anybody else's. But, just quickly, if you could comment, each of you, is this something that we need to worry about? What, in particular, should we be worried about? How would each of you define us to be? And, if this is a problem, what do we do?

Mr. PRESTOWITZ. Well, I think you are right. I think jobs is one aspect of usness, but there is also the question of where technology is developed and where standards are set, and where the profit flow is going. And so I think usness has to encompass more than just a simple question of where are the low-skilled jobs or the assembly jobs or what have you. You have to look at the totality of it.

But, having said that, you know, you can get into a long discussion of this. I think there is a fairly easy dividing line. First of all, whoever the participants are, whoever the actors are, if they are making net positive contributions to the U.S. economy, they should be welcomed.

Recently, I was asked a question about the Japanese auto transplants. The Big Three brought some cars up here to show to you people on the Hill, and some of the importers and the transplants complained that they were not included, even though they have operations here and they employ Americans. And the question was: Well, who is American and who is not?

Well, if the transplant operations were creating net jobs in the United States, if they were creating net additions to GNP in the United States, that has got to be good for us. And that is what we want. So, it seems to me that, you know, one way of looking at this is just to answer that question: Is there a net positive contribution here in terms of jobs and GNP? If there is, it is hard to object to them.

The second thing I would say——

Senator ROCKEFELLER. But then that means you automatically vote for NAFTA; does it not?

Mr. PRESTOWITZ. Well, I am not sure I follow your logic.

Senator ROCKEFELLER. Because everybody says that the net is going to be in our favor.

Mr. PRESTOWITZ. Well, everybody has not said that. I mean, there are a lot of analyses.

Senator ROCKEFELLER. There will be devastation in West Virginia, but the net will be in our favor. Those are the figures I read.

Mr. PRESTOWITZ. Well, I would say not everybody has said that. And it is not at this moment clear, it seems to me, what the net balance would be. But, in terms of individual actors, how should we respond to a Mexican company operating in the United States, it seems to me that you have one response to that company if they are creating net jobs in the United States than if they are not.

Another aspect of this has to do, it seems to me, with strategic positioning. For example, recently, there has been discussion about the British Airways investment in USAir. It seems to me that an investment, let us say, by a bunch of European rich people in a financial investment, let us say, in one of the U.S. airlines is a wholly different kind of investment than one in which, let us say, Air France were to buy out a U.S. airline.

And one of them has to do with seeking financial gain; the other one has to do with strategic advantage. And once you get into strategic advantage, you then get back to these questions of: Where are the jobs? Where are the flows of technology? Where are the flows of capital?

Dr. THUROW. I think Clyde's answer is basically right, and that is that there are a whole constellation of things you want to look at—jobs, technology, management, control, and the key word is net, but it is not net on any one of these things. This may be one of those things like the famous Justice of the Supreme Court—I have forgotten who said it—it is very hard to define pornography, but I know it when I see it.

The Japanese have hard no hard time figuring out who is Japanese. They have got some very international companies, but they knew who is us. And I think this is one of those places where if you try to write down on a piece of paper the exact rules and regulations in a legalistic, Anglo-Saxon way, who is us and who is not, you could tie yourself up in knots forever. But the basic bottom line is: We know it when we see it.

And I do not think, as a practical matter, other countries have found it to be a big problem. The French know who is us. The Germans know who is us. The Japanese know who is us. And in some sense, if by no other reason, the people who are not French, German, Japanese, they are us, because they are not included in any of these other us's, I think is one answer.

I mean, that is a bit flip, but I do not really think it is a huge problem.

Mr. PRESTOWITZ. I would just add one other thing, though. I think that there has been some confusion around this question created by I guess kind of false statistics. I mean, you made the point that an American company that does all of its production in Singapore and Mexico—is it really an American company? Well, there are not very many American companies that do that. I mean, just recently, for example, I saw a report that said that 75 percent of the American semiconductors sold in Japan are made in Japan. That is just flat wrong. That is flat untrue.

But these numbers kind of get thrown around. I mean, in one of the books on this topic it was said that Motorola makes its pagers that it sells in Japan in Malaysia. That is just flat wrong. It does

not. But that has become part of the kind of accepted intellectual environment of discussion, that there are a lot of American companies that do all their production outside, and that there are a lot of foreign companies that do all their production here. It is just not the case. And I think that if we get over that factual issue the question becomes much less pressing.

Senator ROCKEFELLER. One more quick question, Mr. Chairman.

I might say this to Dr. Thurow. You brought up the question of antitrust, and I totally agree with you on that. Whether it is automobile companies getting together on flexible fuel vehicles or whatever, where it is in our national interest, why should we impede ourselves from that?

But my question of you is: How fast, in fact, is American business, in your judgment, moving intellectually, or spiritually on that subject?

It is amazing to me in this whole health care debate how many people hear the word—you know, you will mandate a business that does not offer health insurance to offer health insurance, and how business really, deep in its soul, hates that word, the Government will tell them to do something. Now, in the other case, it is allowing them to do something. But this sort of theology of the separateness of Government and industry, which is so crucial to our deficiencies in competing and which is so crucial to others sufficiencies in competing is an interesting matter.

Do you think that just as you talk with business people across our country that they are shifting, moving, understanding——

Dr. THUROW. Well, I think there has been a revolution in this area. As a business school dean, you spend a certain amount of time talking to the business community across America. And they do not want a government-dictated industrial strategy or trade strategy, but they do want the United States to have a strategy. And I think that is where there has been the revolution. They want to help participate and formulate it and those kind of things, and not in a legalistic sense of tweaking a tax bill.

But I think most American industrialists that I deal with think that the United States, as Senator Hollings just said, you know, is in some sense playing without a game plan. The rest of the world is playing with a game plan, and you cannot win doing it that way down at the individual company level. And so I think, you know, you have talked about the American business community—are they willing to set up some process of talking about how you formulate an American trade strategy or an American industrial strategy—you would find most of the American business community would be anxious to participate in that activity, as opposed to just saying, hey, that is socialism.

Senator ROCKEFELLER. But that does not help me. You did not answer my question. You say they are anxious to participate in a strategy. But you indicated that they want to see a direction. They want to see a strategy, but they do not want to have Government——

Dr. THUROW. Well, what they do not want is just a dictate which comes down from on high. But that is not the way you get to a good strategy anyway.

Mr. PRESTOWITZ. Could I interrupt just a minute?

Dr. THUROW. Yes.

Mr. PRESTOWITZ. Because I think partly there is a semantic difficulty. I was in a meeting recently with a bunch international auto people and the chairman of one of the German companies was there and he kept saying, we do not want an industrial policy; by Jove, we do not want an industrial policy. But then, he kept saying that he wanted the European Commission to negotiate a reduction of the Japanese imports into Europe and he wanted changes in the investment laws in Europe. He wanted changes in a whole bunch of things that sounded like industrial policy to me.

So, finally I said to him, "Listen, I said, you know, I am really confused. You say you do not want industrial policy, but you want all these things that I would call an industrial policy." And I said: "Well, what do you mean by industrial policy?" And he said: "Well, we do not want the Government picking national champions, like the French, you know, pick Aerospatiale or the Airbus or the British pick ICI." And he said: "We do not want Government picking national champions." And I said: "Well, OK, if that is your definition of 'industrial policy,' I understand you do not want that."

But I said: "You know, the Japanese would say that your requests for some kind of managed trade and for special depreciation on advanced robots and for changes in the environmental regulations, all those things which you want to help create a more friendly, positive environment for investment in the industry, that that is all an industrial policy."

And he said: "Oh, well, gee, if that is what you mean by industrial policy, yes, that is what we want."

I think a lot of this has to do with how you package it. And I think American industrialists would welcome a government that sat down and looked at the totality of regulations and negotiations that impinge on the investment environment, talk to them about it, and come up with a game plan.

Now, every company is not going to love every game plan. But I think you would get broad acceptance.

Dr. THUROW. But see, I think there is another big problem if you look at the way we organize Government. If you go to most governments in the rest of the world, there will be some small group of people in, say, that government who are deeply expert on a particular industry, and the chief of that section's job it is to promote the health of that industry.

So, for the United States we have somebody in charge of drug safety, but we have nobody in the bureaucracy whose job it is to say, let us have a successful pharmaceutical industry in the United States. And I think part of the problem is you do not have a dialog of the death, you do not have a dialog. Both sides can hear and nobody is talking. And you have got to start out by exchanging some information and saying, hey, it is an important responsibility of government to worry about a healthy pharmaceutical industry. That is just as important as worrying about drug safety laws.

For example, I think both the President of the United States and the drug industry made an enormous mistake when Mr. Clinton bashed them a couple of months ago about drug prices. Because it takes 9 to 11 years to get a drug approved. It now costs more than it does to invent the drug. And if Mr. Clinton had gone to the drug

industry and had said, "Hey, if I can get that 11-year approval process down to 5, can you cut drug prices in half?" They would have said "Hosanna, we will do it."

Or, even after he bashed them, if the drug industry had said: "Mr. President, we would be delighted to reduce prices 40 percent if you could get the approval process reduced 40 percent in time." And neither side made the obvious request to the other side that they should have made. And I think it was not that there was malevolence on either side, it was just ignorance. Probably nobody had briefed the President—"Hey, the big thing in the drug industry is this 11-year approval process."

Senator ROCKEFELLER. Well, just for the record, 1 month after he made that statement during the campaign in Rahway, NJ, the entire pharmaceutical industry was sitting in my office saying that they would voluntarily hold the cost of their prescription drugs to the rate of inflation. So, he did not make a total mistake. And I understand your point.

Dr. THUROW. No, that could very well be. But he could get the prices down if we could do something about that approval time.

Senator KERRY. Senator Rockefeller, thank you.

And I might just add, thank you for the leadership that you offered as chairman of this particular subcommittee and the steps that you took on export promotion and other areas. We appreciate it.

Let me follow up, if I can, on Senator Rockefeller's questioning, and particularly an answer that you gave to him. You mentioned the Airbus and you talk about these inequality steps we can take. Let me just ask you, in terms of your response about industrial winners and losers and industrial policy and the notion—the CEO said to you, "We do not want to have the Government choosing a champion," so to speak. Now, all of us are quick to say that. We do not want to pick champions. We do not want to pick winners and losers and so forth.

But keiretsu picks winners and losers. The Airbus subsidy picks a winner, a champion. I mean, the air industry is next. Everybody knows it. Lester Thurow and others have picked this as one of the seven targeted areas. And if we sit here and simply say, "Gee, we do not want to pick champions and we do not want to do anything," they will continue to subsidize. They will continue to undercut us in the market. And we will suddenly find we are not selling as many Boeings.

And with the sequence that Lester Thurow describes in his book, the profit margins are lower, the growth rate is slower and when somebody is growing at 40 percent, versus somebody who is growing at 20 percent, even though the 20 percent may have a better piece of market share at the time, you know who the winner is going to be, correct?

So, you cannot sit there doing nothing in response to that. So, the question to you is: Without "picking a champion," what do you do about Airbus?

Mr. PRESTOWITZ. Well, I think there is a difference between picking a champion and letting a champion die. We have a champion in the aircraft industry and it would be foolishness to stand by and do nothing to defend against some of the attacks that are coming.

Senator KERRY., So, does that mean you subsidize?

Mr. PRESTOWITZ. Well, there are different ways to approach it. I think that you get into a tortured situation when you begin just writing checks to companies. But I think there are better ways to approach it. Every Airbus that is sold in this country is dumped.

The Secretary of Commerce has the authority to self-initiate a dumping action. Rather than waiting for McDonnell-Douglas or Boeing to file a case, every time an Airbus is sold, the Secretary of Commerce ought to file a case, a dumping case and a countervailing duty case.

I think that cases in which our aircraft manufacturers are competing, let us say, in selling aircraft to a Thai Airways or a Singapore Airways, I think two things ought to be clear. One is that, if necessary, the United States will match European export subsidies dollar for dollar. And, second, I think that given, for example, we are the ones with the Seventh Fleet in the Straits of Malacca, not the French, the Singaporeans ought to understand that we are providing a lot of things out there and that they ought to be aware of that when they make their buying decisions.

Senator KERRY. Why do you think we do not do that?

Mr. PRESTOWITZ. Oh, golly. One, because we have never really thought it was important. There is a great distance between the people who have guided our foreign policy and the people who have guided our trade and industrial policy.

Dr. THUROW. Right. You can see the change. One of the jokes about Henry Kissinger in the economics profession when he was Secretary of State and head of the National Security Council is Henry Kissinger would tradeoff any economic advantage no matter how big for any political advantage no matter how small. And he was not alone. Because this was the American era.

And of course, what we would do in the good old days in Singapore is we would be worried about basing rights in Singapore so we would give them a little economic extra just to get basing rights in Singapore. But we do not need the American fleet in Singapore any more. They need it there much more than we do. Because it is not a global thing any more, it is local disputes between Singapore and Indonesia or Thailand or whomever.

So, I think the part is the switch in attitude in the United States. And to some extent we still do it because we traditionally pick Secretaries of State, and I guess George Shultz would be the only exception, who are remarkable for their lack of interest in economics, if anything else.

Mr. PRESTOWITZ. But even George Shultz. I mean, I sat in on a meeting with George Shultz once in which the Airbus came up. And the Commerce Department and the Trade Rep's office were proposing to take some fairly tough action, and Shultz was then Secretary of State, and he said: "Absolutely not. It would shatter NATO. We cannot do it."

So, it is that mind set which has really informed so much of this policy making.

Senator KERRY. With respect to Chairman Hollings, he has pursued for about 5 years now, and with considerable success against the tide at the time, the notion of an investment strategy in terms of R&D, high technology, the Hollings Centers as we know them,

technology transfer, and so forth. The Clinton package, the investment package, is now in trouble as we hear. And yet it seeks to do some of the very things that Dr. Thurow and others have talked about so much—the R&D tax credit, the defense conversion programs, and other similar efforts.

Do both of you—I know Dr. Thurow's answer is affirmative—agree on the need to do that, notwithstanding the fiscal constraints and deficit constraints that we live under?

Dr. THUROW. Well, if you look at R&D budgets, the last time I looked up the numbers, Japan was putting 2.8 percent of the GNP in research and development, the United States was 2.7, and Germany was 2.6. So, for all practical purposes, we were the same, except, basically, every dollar in Germany and Japan went into civilian activities, and in the United States 1.1 percent of GNP was military R&D, which means if you subtracted it from the total, we were putting in only 1.6.

I think the problem is, and you see it very clearly at my institution, MIT, the military R&D is now falling very rapidly. You know, when they first started doing defense cutbacks, they said the last thing we are going to cut is R&D—in fact, it is the first thing they cut because politically there are fewer votes there than there are in the factories.

And we are not going to survive putting 1.6 percent of GNP into research and development while our competitors are doing 2.7. And so the question is: Can you ramp up the civilian R&D system fast enough to replace the military R&D system as it phases down?

I think one of the problems we may very well have is I guess I have some long run confidence that we will do it, but the timing will not be right. The military system will collapse faster than the civilian system grows, and you are going to have some major American scientific institutions that are going to go through some wrenching cutbacks, and then later on, they are not going to be there when you want to have them.

And my institution, MIT, may very well be one of them, because if you look at our budget, we have a budget of $1.2 billion—$400 million is education, $800 million is research, and about one-half of that research money comes from either the defense or the military parts of the Energy Department. And so, if it just goes away, a place like MIT is going to be doing about one-half as much research as it has been doing.

Mr. PRESTOWITZ. And just to add to that another aspect of this, not only do you subtract out, let us say, a big piece of the defense R&D, but our R&D spending, Government R&D spending, tends to be much more heavily weighted toward basic research, whereas that in Germany and Japan tends to be much more developmentally oriented. And, in a sense, we are providing their seed corn. We are doing the basic. This is a very open R&D atmosphere. They take that stuff and then they spend twice as much as we do on developing it. And the result is that we get the Nobel prizes and they get the markets.

Dr. THUROW. I had an interesting experience along this line in Hong Kong. Because if you take LEC displays, they are now basically all made in Japan except for a couple of small companies in Hong Kong that make the high-end stuff. They are not made in the

United States at all. But these Hong Kong companies are too small to do the kind of fundamental research and so I said: "How do you keep up with technology?" You know, when I was out there not too long ago. I said: "Do you get any technology out of Japan?"

The answer, like everybody else, is: "No, we get nothing from Japan." But what we do do, is we send our scientists to American research conferences on LEC displays, because the American military is still funding some fundamental research that American professors do, and we get all our technology basically from the American military and the Americans do not make this product any more.

And so the whole world, in some sense, in terms of basic research, has been living off of American military R—not the D, but the R.

Senator KERRY. That is interesting.

And apparently there is not much cooking to try to address that or reverse that?

Dr. THUROW. You do not see too much; no.

Senator KERRY. Which is ominous as you look down the road, in terms of those high-skilled jobs, for the training that you are talking about and that Senator Hollings was talking about.

Dr. THUROW. Well, see, here is something I think we ought to be talking about in GATT, because, if you think of it from a narrow economic perspective, we all should be doing the D and forgetting the R. If you think about it from a world perspective, we should be financing R. Now that there are a lot of, you know, wealthy countries in the world other than the United States, in some sense there ought to be a World Science Foundation that finances R for everybody's benefit, not just America financing R for everybody's benefit. And those kind of things are some of the cooperative things that you could do in that framework.

Senator KERRY. Well, is there not a way to finance the R and hold on to more of it, turning it into the D?

Dr. THUROW. Well, to some extent, but the real problem with R is it tends to have a 20- to 30-year time payoff, and by that time everybody knows about it. I think it is easy to get economic advantages out of the D. It is much harder to get economic advantages out of the R.

Senator KERRY. Dr. Thurow, in your book you talk about the consumer electronics industry, and you graphically describe the semiconductor piece of that. What possibilities are there with respect to the higher margins that we demand, our investors demand in this country, versus those that the Japanese and Germans are willing to live with, and the impact that has?

And I suppose a corollary question: Why are the Japanese companies able to pursue market share at all costs while we obviously are not? Again, it goes to this different set of expectations we are living by, I suppose.

Dr. THUROW. Two reasons. One is, particularly in the case of Japan, for a long time the big companies in Japan have had relatively low cost of capital, partly because of the fiscal policies of the Japanese Government and partly because of the peculiar structure of the Japanese financial industry and its relationship to big industry.

Second, because the Japanese market has been protective, so they have been able to make pretty high margins in Japan and use that to subsidize market share wars elsewhere.

The Germans are much less market-share oriented than the Japanese. The German industry has to make money in a much more real sense than the Japanese industry does.

Mr. PRESTOWITZ. I think it is fair to say that those things have changed somewhat. The cost of capital in Japan has gone up and it is not quite as it was in the late-1980's. The Japanese market continues, of course, to be a sanctuary for Japanese industry.

I do not think there is a silver bullet answer to all of this. Part of it is to reduce the cost of capital in the United States by doing some of the things Paul Volcker is talking about and that Lester talked about. Part of it is trying to batter your way into the Japanese market. Part of it is changing corporate governance in the United States so that you create incentives for longer term investment horizons.

Part of that is a couple of ideas that have been thrown out are sliding scale capital gains taxes, high in the short term, low in the long term. Another idea has been a cumulative voting power. The first year you own a share you have one-tenth of 1 vote. The 10th year you own the share you have a whole vote.

Other ideas have to do with changing the taxation of corporate dividends and changing the tax treatment of interest payments so as not to give such generous benefit tax deductions to interest payments.

Again, it comes back to, do you have a strategy? Do you have a geoeconomic strategy? Do you want to be competitive?

Dr. THUROW. Let me give you an example of how we could meet that particular requirement. Suppose you levied a value-added tax big enough to raise enough revenue to replace both the corporate income tax and the payroll tax. One of them is the biggest tax that the shareholders pay or may pay; the other, workers think of them paying, but it would just be may pay. But you are dramatically reducing the cost of American industry.

You know, it used to be, let us say, that they had to have a 20-percent gross rate of profit return to get 10-percent net; now the 10-percent net is all they need, not the 20-percent gross. And at the same time, you buy yourself something in world trade because all of these taxes companies pay on the products they export to the rest of the world, they get rebated, so that they become more competitive in foreign markets.

So, I think if you think systematically about the tax structure of the United States, if you could be radical, you could put American companies in positions that would be very comparable to Japanese companies in terms of what they had to go for in this way.

Now, the ideal thing, if we could follow Senator Hollings, would be I think if you did a value-added tax you would want to do a big tax. And I think you would want to tell the American people you are at least getting rid of a lot of paperwork. And so I think the right way to do it is levelling it at a substantial level. In Europe, it is usually about 20 percent. And wipe out a couple of these big taxes, like the corporate income tax and the payroll tax. Because that is also happening on the job side.

Because the biggest cost handicap in a place like the United States on the job side at the moment is not wages. It is the fringe benefits and payroll taxes. I mean, some of our wages are remarkably low. I was talking to a timber person in Montana a week or so ago when I was giving a commencement address there, and he kind of shocked me, because even though I think I know about the world—he said: "You know, what I pay lumberjacks to work in Malaysia is almost as high as what I pay in Montana."

Now, if you look at the fringe benefit side, I pay the Montana people a lot more. But, in terms of cash wages, the Malaysian lumberjack was making almost as much as the Montana lumberjack. And so if you could move those payroll taxes and the corporate income tax over onto the value-added tax, you might be able to argue as politicians, I have gotten rid of two taxes—one the biggest one that human beings pay, the payroll tax, one that is going to cut the cost of capital by one-half. And I do something for the Government deficit too.

Senator KERRY. Well, that is a recommendation that is falling on the ears of two of maybe five champions of that effort here in the Congress. [Laughter.]

And Senator Hollings has taken the leadership on the floor on it. I could not agree with you more.

Senator Hollings.

The CHAIRMAN. Right quickly, why do we not start with the national security provisions? You say with regard to the LEC displays or the flat panel displays, that the Japanese said we could not have fired that Tomahawk missile without their particular Japanese displays that we are using in national security. But national security goes beyond technology.

Our friend Gary Hart was always going around talking about high technology, high technology and unfortunately, that virus is still alive and everyone thinks that is a quick fix.

Thirty-two years ago, President John F. Kennedy promulgated a seven-point textile program. In order to do that, he had to have authority under what we call a national security provision. He appointed George Ball, Arthur Goldberg, Luther Hodges, Orville Freeman, and Doug Dillon, and the five-member Cabinet committee had hearings and determined that, next to steel, textiles was second most important to our national security.

We could not send our troops to war in Japanese uniforms and Gucci shoes, incidentally. I always like to add that.

So, he could promulgate that seven-point program, and it goes right to the economy. A nation, in foreign policy and otherwise, like a three-legged stool. One leg consists of your values as a country; the second leg is your military strength, which is strong; and that third leg is the economic leg, which is fractured at the moment, and we need to bolster it and rebuild it.

In that light, the largest employer of women, the largest employer of minorities is the apparel industry. Nylon comes from my South Carolina textile ATMI crowd, and with GATT, Dr. Prestowitz, and you know them well, they say: "Whoa, we cannot have GATT; we cannot phase out the multifiber arrangement over a 10-year period with any reductions in tariffs because we have got studies showing we will lose 1 million jobs."

But they come now with Mexico and say: "Oh, let us have NAFTA. Whoopy for that free trade agreement with Mexico, because we are going to lose 1 million apparel jobs there, but we do not care about the million apparel workers, we are going to sell the cloth and make a fortune."

I think the strategy perhaps ought to begin not just with technology or nontechnology or winners and losers, but with those things fundamental to our national security. Two-thirds of the clothing we see in this room is imported, and if that figure goes up any further, you will not invest, you will not be competitive, you will not be productive, and then we will have lost that industry. And somebody said: "Well, so what? That is what they told us back in the fifties."

"Let the LDC's, lesser developed countries, make the textiles and shoes and we will make the airplanes and computers," they said. Now, 40 years later, they are making the airplanes and computers and we are about to lose all of textiles and all of shoes and everything.

Do you have a comment on that? That still remains true about the national security provision.

Dr. THUROW. I think you are right. The issue is not high technology. It is how you upgrade your industries in terms of wages and profits.

The thing I always point out in textiles and garments is that there are two textile garment worlds out there. One is kind of the mainland China, make white man's underwear, where it is clearly a low-wage industry. And Americans are not going to want to work at the wages which Chinese are going to work at.

On the other hand, there is out there an industry which the Germans and Italians dominate, which is a high-wage, high-fashion, rapid turnaround textile industry, that can pay very high wages. And what you want to do in the United States is make sure that you are, in some sense, moving from that low-wage underwear Chinese textile garment market into the high-wage garment textile market that the Germans and Japanese dominate at the moment.

And so it is not so simple as to say high technology. I am with you 100 percent on that. But you need to be worrying about all of these industries. How do you upgrade them so that they can, in fact, afford to pay higher wages? Because that is the name of the game.

The CHAIRMAN. Thank you, Mr. Chairman.

Senator KERRY. Just a couple of quick questions, if I can.

Take for example a State like our State, Massachusetts, where we have had so much dependency in defense industry, high technology, computers, and so forth, all of which is in a downturn. And these folks are out there now really looking for ways to increase. One of the most significant increases has been exports. And it is a significant base of our economy in the State.

Do you see, without the Clinton conversion piece, the R&D components, the additional expenditures on infrastructure and training? Do you see us adequately meeting the needs of those folks to be able to make that transition?

Dr. THUROW. I do not think you can make the transition unless you are willing to do some of the investments. Remember, what

was the GI bill? The GI bill was the post-World War II human skill transition bill. That what it is was about.

It was taking these 12 million people that were going to be dumped out of the American Army and putting them back into the economy at a much higher skill level than they had come out.

And if you looked at that transition that we did at the end of World War II, it was a managed transition. It was not just, throw everybody out and let the market do what it will. And I think——

Senator KERRY. When you say "managed transition," it was managed because we had the GI bill, we had the investment in housing, we had the national infrastructure expenditures on roads?

Dr. THUROW. Interstate Highway System, a whole set of things occurred in the 10 years after World War II. And see, I think the real issue in the United States at the moment is not Government versus private, it is consumption versus investment.

We want to hold down consumption or stop it from rising so rapidly in both the Government and in the private sector and we want to push up investment, both in the Government and private sector.

And see, I think that is why the health care thing is so important. Because health care spending is, in fact, consumption. It is 60 percent in the private sector, 40 percent in the Government sector. It is out of control in both sectors.

I noticed the other day, the Japanese have reduced their health care spending from 6.8 percent of GDP to 6.2. Now if we are spending 14, that means every American industry starts off with an 8-percent cost handicap on day No. 1, if you are building health care costs into the payroll costs, which is what we basically do.

You cannot afford to do that on—either in terms of using your resources that way or organizing yourself competitively that way. If you wanted to spend 14 percent on health care while the Japanese are doing 6 percent, then you have got to get it off the backs of businesses and pay for it in some kind of a tax sense, so it does not have to be rolled into the prices.

Now the right answer, of course, is if the Japanese can be healthier than we are, and they are, and spend 6 percent of GNP on health care, then there has got to be some way we can spend a lot less than 14 percent and cover everybody.

The CHAIRMAN. And they can save on that Pontiac car I have. They save $5,000 making it over in Montreal on health care costs. So, that is why General Motors had to go over to Montreal for that car to be produced right there. That is a $5,000 difference on health care.

Senator KERRY. Gentlemen, time precludes us from digging into some other areas that we would like to. I just want to quickly bring up that, at the World Economic Forum, you made some comments regarding decoupling. And you subsequently, I presume, had those published as an article. Partly what we have been talking about this morning, is this notion of how we proceed if we cannot get our growth in a cooperative manner with other countries operating by some rules.

Then you advocated that in order to get the growth from simply practical political reality, the President may have to decouple. Do you adhere to that still?

Dr. THUROW. Yes. If you mean that you cannot just sit here as the American economy being the economic engine for the rest of the world, running up ever bigger trade deficits.

Senator KERRY. We cannot reduce consumption and simultaneously be the locomotive for the rest of the world.

Dr. THUROW. Absolutely not. You cannot do that. I was just reading the forecast for the next 12 months, the Data Resources just came out with. They think that the U.S. trade deficit is going to deteriorate by $35 billion in the next 12 months. It will be $35 billion bigger 12 months from now than it is now.

Well, in the United States, basically every 45 billion dollars' worth of manufactured imports means we lose 1 million jobs. Well, Mr. Clinton is going to be losing three-quarters of 1 million jobs if that forecast is right. How is he going to generate an economy in the United States that generates more jobs while you are losing three-quarters of 1 million jobs to the trade deficit?

I think the answer is you are not. Now you can sit here and say, well, we are just going to—I think if you listen to Mr. Volcker's testimony this morning, it was a little bit discouraging, because he says, "Well, the rest of the world is growing slowly, and therefore we do not have any choice but to grow slowly."

Senator KERRY. Well, I had the same reaction, I must say. And it struck me that there was an underscoring of the philosophical clash that we are facing right now.

I mean, there are those who are going around saying, "Hey, it is not as bad as it was. They seemed to have opened up a little bit." But they are missing the point with respect to the major cultural, philosophical, and economic foundations on which their notions of competition are based versus ours.

Dr. THUROW. I think, I want to make a comment that comes off Clyde's point about savings and investment in these macroeconomic identifies that have to hold. If you are going to reduce the budget deficit, we have to be reducing the trade deficit at the same time. Because if you think of what are the economic locomotives that can keep America growing while you are either raising taxes or cutting spending—I do not care which you do for this purpose.

There are only two. One is lower interest rates. And I think in 1993–94, the American economy, for better or worse, is going to be riding the interest rate locomotive. But by the time 1994–95 comes along, the interest rate momentum will be spent and the only thing that can keep the American economy growing as you are raising taxes and cutting spending out there in 1995–96 is if the trade deficit gets smaller.

And so, you know, it is not just that we cannot afford to let it get worse. In some sense, if we want to have a successful economy over the next 4 years, it has got to get better.

Senator KERRY. Well, I think your statements, sir, are very important ones. I hope that we will be able to somehow take heed. There is not a great record around here of this place responding adequately, neither the Executive nor this institution.

But I do think there are some stark realities with which people are coming to grips, and I know that, at least speaking for myself, this is the battleground. This is where all our energy has to go. And if it does not, we are going—I think—to regret enormously

that we ignored your warnings and some others that have been laid in front of us.

So, we really particularly thank you. I know you have traveled down here a number of times this month and I hope you are not getting exhausted by it. It is really most helpful to us and we are very, very grateful to you for it.

Thank you very much, Dr. Thurow and Mr. Prestowitz. We are going to try to proceed directly to the last panel if we can and go right through here.

So, I would ask if we may for Mr. Spriggs and Mr. Housman to come forward.

Gentlemen, thank you. We are very grateful to you for being patient and waiting, although I think it has been interesting. And I have noticed your heads nodding here and there, and so you have been engaged.

Obviously, we are very anxious to explore with you ways in which we "harmonize up" as Mickey Kantor has said, rather than sinking to the least common denominator as we engage in these environmental and worker safety standards issues.

And clearly, the labor standards and the environmental standards become central components of arriving at an understanding of the disequilibrium or equality of our relationships. If countries are not going to do what we are doing and our corporate entities are having to ante up, it is part of that cost that we were referring to earlier, just as the health care benefits are a cost.

As the pressures get greater, I think we are going to see increased pressures for people to try to find ways to avoid or change some of those rules. That clearly is not good. And it is going to be a very significant part of the equation, I think, as countries sit down and try to talk about and quantify the different elements of these relationships.

So, we look forward to your testimony. And without further ado, unless Senator Hollings wants to say anything, you could just proceed with opening statements, we would appreciate it.

STATEMENT OF WILLIAM SPRIGGS, ECONOMIC POLICY INSTITUTE

Mr. SPRIGGS. Thank you for inviting me, Senator. And greetings to you, Senator Hollings.

I think that you are right, that the labor rights area is very important. Unfortunately, our trade policy typically has not really concerned itself with the labor rights issue. I think that there are two major reasons why that is the case. Though, clearly we can identify different parts of trade legislation that do contain information and regulations on labor rights.

But I think there are two basic reasons why we have ignored it. One of those is that international trade economists have in their mind a world in which everything works in a purely competitive framework and where the wages of workers reflect their productivity.

So that trade economists never get bothered with the notion that some workers get paid less than other workers. In their minds, that reflects the lower productivity of those workers. And so to

them the issue of workers' rights is a social question and not something that has economic content.

The reality, however, is that the wages of workers in low-wage countries does not reflect their lower productivity. This is faith on their part, on the part of a lot of trade economists, that low wages means low productivity.

But when people have actually looked at the actual issue of what is the productivity of workers in these low-wage countries, what are their wages, what does that get you in terms of unit labor costs, the actual evidence is that there are unit labor cost advantages in a lot of low-wage countries and particularly in the manufacturing sector.

The other part, of course, is that domestically, and in particular over the last 12 years, we have not pursued, in our own country, an aggressive program to defend the labor rights of American workers. And this just shows up in all sorts of statistics about what has happened in the last 12 years domestically.

If we just look at things like unfair labor practice cases, which have come before the National Labor Relations Board, before the 1960's we would have somewhere around 10,000 each year. During the 1980's, that number doubled to around 20,000 each year. And this is with a smaller share of the workforce being unionized. So, this is really remarkable to have more unfair labor practice charges, even though we have fewer unionized workers.

And more of those cases are, in fact, valid. That is, a lot of the cases just get dropped or dismissed; during the 1970's you had roughly 70 percent of the cases were simply withdrawn or dismissed. In the 1980's, it was 60 percent.

And as a consequence today, if you were to bring an unfair labor practice charge as a worker because you had been unfairly dismissed, it would take you 750 days, on an average—this is the median actually—it would take you 750 days to get the National Labor Relations Board to give you a decision. Whereas, before the 1980's, it would take somewhere under 500 days.

So, it takes well over 2—it takes almost 2 years for you to finally have someone say, "Yes, you were treated wrong and you can get your job back."

So, we have had two things going on, which is that domestically we have been saying to American workers, the way that we want to compete is we do not want a lot of rights for American workers. And then we have, within the trade establishment, the theoretical underpinnings for a lot of what we do in trade.

And Senator Hollings, you mentioned this. This faith and this altar that says free trade is good and this theoretical world that says that wages reflect productivity, and so therefore workers' rights do not matter. But they only do not matter in that theoretical world.

Now this means that a lot of companies are able to gain some sort of cost advantage, depending upon the environment, the worker right environment in which they operate. And as Professor Thurow was pointing out, today what goes on is that, at least in manufactured goods, it is the case that what we have is "manufactured" comparative advantage. That is, the rules of the games matter.

And one of the rules of the games which would of course matter the most is the one input which is not a traded good, and that is the labor input. You know, you could do all sorts of rules to try and impact all the inputs that a company faces, but those are mostly traded goods and there is little that you can do. But you can do a lot about what would happen to workers' right.

Now there have been some studies which have been undertaken to look at unit labor cost advantages. And to just give you a picture of how that can impact the United States, if you look at a lot of the low-wage countries with whom we compete now in manufactured goods, you can see that the eighties also was a time period in which we increased our imports from those countries in manufactured goods by a lot.

Brazil, we increased our imports by over 300 percent, Korea by almost 400 percent, Mexico by 300 percent, Singapore by 300 percent. All of these are massive increases in the—percentage of—percentage increases in imports from those countries.

When you look at Mexico, just as an example, and look at their productivity in the modern sector. Take electronic equipment as just one of the examples, because we talked about consumer electronics earlier in the afternoon. And you can see that, the evidence would tell you that in electronics, Mexican workers attain something close to 80 or 70—between 70 and 80 percent of U.S. productivity. Yet Mexican workers are compensated on a level that is closer to something like maybe 15 percent of U.S. wages.

The same thing would occur if you looked at transportation equipment, where on average Mexicans attain something like 60 percent of U.S. productivity while they are getting something like 12 percent of U.S. wages.

Harley Shaiken, who teaches at the University of California, San Diego, has done a study where he has looked at plants run by a corporation that has plants in Mexico and a plant in the U.S. Midwest and we has been able to compare the engine productivity. It is a company that produces engines. He has been able to measure productivity because these are like products and they are using similar technologies, and has been able to document that, the Mexican productivity rate for that same product is somewhere close to 94 percent, which is of course going to be more accurate than just looking at national averages.

In the case of Korea, some Federal Reserve economists have looked at this issue and found that Korea enjoys a very big unit labor cost advantage.

Now where does this unit labor cost advantage come from? Some of it comes from the fact that developing nations have a dual labor market, so that workers in the modern sector have their wages held down by a large supply of workers who are not in the modern sector. So that is part of the reason.

But the other part of the reason is because those workers do not enjoy the same type of labor rights that we would recognize here in this country. Now, it gets to kind of a de facto/de jure issue, because if you looked at Mexico's labor code, its labor code is actually better than the U.S. labor code if you were an American worker.

Senator KERRY. But it is not enforced.

Mr. SPRIGGS. That is right, and the same thing with environmental. So, it is an issue of looking at the facts as opposed to, necessarily, their laws. There is a study that has tried to approximate this by Peter Dorman. And what Peter did was look at a measure from the International Labor Office and from the U.N. of what kind of rights exist in low-wage countries.

His study says that if you can change a country's grading just by one level and get more rights, you change the wages of those workers by 30 percent. And when you look at the unit labor cost advantages that some of these countries have on us, that is almost the labor cost advantage that some of them have on us. So, if we could have labor rights which would at least raise them one notch, then we would be better off.

Now, part of the problem comes about because American workers not only compete against countries that have this environment, but they are forced to compete against U.S. companies who see that environment and are willing to take advantage of it. If you look at the increase in manufactured imports from Latin America and Asia, that are coming from U.S. corporations, it is really astonishing the rate of increase that took place during the 1980's.

So, the question becomes, Can we get trade policy in the United States to finally say "Look, we have addressed intellectual property rights, and we understand that there is an issue there. We have addressed the issue of subsidies and we understand that there is an issue there, or at least we are attempting to address the issue of Government subsidies, but we also have to think about the issue of worker's rights, and it must be much more forceful than is the case today."

We all know that when the original NAFTA agreement came down, there was a chapter to make uniform what the intellectual property rights would be in the three nations, there was a chapter that made uniform what the government procurement rates would be, but there was not a chapter to talk about labor rights.

Could we operate on the framework of national law, national standards? Well, I think that the danger in working on that level is that unless you recognize that labor rights can, in fact, give a cost advantage, that you must then agree that there is some standard, and it cannot be national standard. Otherwise, of course, what a country could do is say, "OK, you do not like the fact that I do not enforce my severance pay law. Okay, we will not have a severance pay law."

So, unless we are going to have the reaction being, I do not enforce my law therefore I will lower my law to conform to what I am willing to enforce, then we are going to have to agree what those standards are. And it is a silly game to say that that would not take place because that, of course, would be the reaction.

Senator KERRY. If I could just interrupt you for a minute, why do you believe this was not part of the original negotiation? Now it is in side agreement status, not in the original agreement with NAFTA? Simply because of philosophical difference in the Bush administration or was it too difficult to get agreement on?

Mr. SPRIGGS. No, I think it is twofold. One is the philosophical area. But the other is, and we are seeing it now, that those busi-

ness interests in the United States that want to operate in Mexico are the ones who are saying they do not want the side agreements.

Now, I think this gets back to the who is us type of question. And that is that there are going to be corporations which could benefit from NAFTA, but they could only benefit if Mexico continues with certain regimes, one of those being its labor rights regime.

So, I think part of this is philosophical, but part of this is who stands to benefit from NAFTA and if the side agreements take away those benefits then we are back to the models all of which say nothing happens with NAFTA, no one really gains or loses.

In those theoretical models which are looking at a theoretical world where everything is fine and works in a perfectly competitive way, well then, you know, all those models tell us that nothing would happen. But that is not the reality. There are real differences and there are possibilities of taking advantage of those differences, one of those being labor rights. So, I think that is part of the motivation for why it was not there originally.

But if you look at the structure of the U.S. Trade Representatives Office itself, though, you see that there is not someone there for labor rights. And that kind of speaks to the mentality of what is important, what has to be made level. Intellectual property rights have to be made level, but labor rights do not.

And if you look at how complex that chapter is on intellectual property rights, then it is clear it is not simply that it is complicated because that was a complicated chapter to come to agreement on.

Given that Mexico has signed on to and agreed to many ILO conventions, it is not as if there are not some basic standards from which the agreement could have begun. So, I do not think that it was too complex.

Senator KERRY. We want to have time to get both in because we have a democratic conference backing up on us a little bit here. I do not want to cut you off, but if you can summarize, if you left out any points——

Mr. SPRIGGS. Well, I really did not want to come here with a lot of proposals, but what I did want to come with was to encourage you to continue with the interest that you do have on labor rights, and to make sure that if we are going to continue with opening up markets in the way that the NAFTA suggests, if we are going to have a GATT round in which we are going to continue to be concerned about subsidies, then we do have to recognize that labor rights form a way in which countries can and do subsidize operations.

And that if we do not recognize that as being as equally harmful as everything else that we see as harmful, then we are going to be missing the point.

[The prepared statement of Mr. Spriggs follows:]

PREPARED STATEMENT OF WILLIAM E. SPRIGGS

Various pieces of U.S. international trade and investment law contain language that seeks to limit the granting of privileged access to the U.S. market, or limit supporting direct foreign investment, to nations that adhere to basic internationally recognized labor rights (for a discussion see U.S. Dep't of Labor, 1991). Generally, these rights correspond to major International Labor Organization (ILO) conventions, and include:

A. the right of freedom of association (ILO convention #87, adopted in 1948);
B. the right to organize and bargain collectively (ILO convention #98, adopted in 1949);
C. prohibitions against the use of forced labor (ILO convention #105, adopted in 1957);
E. standards with relation to wages (ILO convention #131, adopted in 1970), hours (ILO convention #14, adopted in 1947 and extended in convention #106, adopted in 1957), and the safety of working conditions (ILO convention #155, adopted in 1981); and
D. a minimum age for child labor (ILO convention #138, adopted in 1973).

The legislation that is currently affected by these limits are: the Caribbean Basin Economic Recovery Act (1983), Title V of the Trade and Tariff Act of 1984 (the Generalized System of Preferences (GSP) Renewal Act), the Overseas Private Investment Corporation (OPIC) reauthorization of 1985, Public Law 100-202 (Authorization for U.S. participation in the Multilateral Investment Guarantee Agency (MIGA) of the World Bank, 1987), the Omnibus Trade and Tariff Act of 1988.

Currently, the connection between labor rights and international trade is not generally discussed by most international trade economists or policy makers. This is the case for several reasons. Two major reasons are the theoretical underpinning of international trade policy, and the other is the domestic economic agenda of the last twelve years.

Though Section 301 of the Trade Act of 1974 does define "any act, policy, or practice or combination of these which constitutes a persistent pattern of conduct that denies worker rights as unfair trade practice (U.S. Dep't of Labor, 1991, p. 12)," U.S. trade policy has virtually ignored worker rights. Consequently, the body of the North American Free Trade Agreement (NAFTA) does not address the vast differences among the U.S., Canada, and Mexico in the interpretation and protection of worker rights, but it does smooth the differences among the countries' intellectual property rights and government procurement rules by devoting an entire chapter to each of those subjects.

The GSP Renewal Act of 1984 gives the U.S. a way to remove duty-free import status from developing countries if those countries violate the labor rights provision of the Act. Yet the only countries to have their GSP status suspended or removed are: Burma, the Central African Republic, Chile, Liberia, Nicaragua, Paraguay, Romania and the Sudan. A list that is suspiciously thin.

Until recently, trade theory was dominated by models that assumed perfect competition and constant returns to scale in production technology. The traditional theory argues that removing international trade barriers would lead a country to specialize in exporting those goods that it can produce more efficiently relative to other goods that the country produces—their "comparative" advantage (based on the initial work of David Ricardo, 1951.). Most policy makers, recalling their undergraduate economics courses, are familiar with this theory. The noted international trade economist, Paul Krugman, has written, "If there were an Economist's Creed, it would surely contain the affirmations 'I understand the Principle of Comparative Advantage' and 'I advocate Free Trade.' (Krugman, 1993, p. 2)"

In that theoretical world, the wages of workers would reflect their productivity, and countries would operate at full employment. That world view sees the wages of workers—labor costs—as independent of national institutions (as an example see the discussion of the Heckscher-Olin Model, in standard undergraduate text like Caves and Jones, 1973, Chapter 8). So, those economists view a discussion of workers' rights within the context of a social agenda.

While trade economists have now updated their theory to include the possibilities of monopolies, increasing returns to scale in production technology, and other market imperfections, generally, trade economists have failed to keep pace with labor economists in theories of wage determination. Armed with the world view of the old school of trade economists, policy makers pushed for international trade free of tariff barriers. With the new school in ascendancy, some policy makers now talk about "strategic" trade to address the problems raised by trade in a world with market imperfections. So, the improvement in trade theory has still left the discussion of workers' rights as a social issue.

Ignoring labor rights abroad is not inconsistent with the attention given workers domestically the last twelve years. Evaluating the domestic agenda, many labor economists have documented the declining fortunes of America's workers. Recent research has highlighted the failure of the policies of the 1980s to reduce poverty or some aspect of the decline in earnings for African-American males relative to white males, high school educated workers relative to college educated workers, and high school educated private sector workers relative to high school educated public sector

workers. The general theme is that there was a large increase in wage inequality in the U.S. during the 1980s. Some of the researchers who have documented these trends include: Mckinley Blackburn, David Bloom and Richard Freeman (1990), David Cutler and Lawrence Katz (1991), Katz and Alan Krueger (1991), Lawrence Mishel and Jared Bernstein (1992) and John Bound and Freeman (1992).

But the experience of the 1980s was new. The trend among industrialized nations during the 1970s was toward wage equality. In the 1980s, the U.S. was different from other industrialized nations for having a large increase in wage differentials. Though England, by pursuing some policies similar to the American policies, also had a large increase in inequality; the U.S. was unique for having wages fall so dramatically for the lower end of wage earners. In explaining why the U.S. pattern was so unique, researchers Katz and Freeman (1993) concluded that:

> Differences in wage-setting institutions and in training and education systems also explain some of the differential growth in inequality. Countries where labor market institutions (by which we mean unions, employer federations, government agencies) play a greater role in wagesetting and which provide better training or education for less skilled workers had smaller rises in inequality in response to similar demand/supply shifts as the United States.
>
> Changes in labor market institutions contributed to changing wage inequality. The decline of unionization in particular contributed to rising wage inequality in the United States and the United Kingdom.

Their finding is not surprising. The domestic agenda for the last twelve years has weakened American worker rights (Spriggs, 1991). This can be shown in the ominous rise in labor-management friction since the end of the 1970s. The number of unfair labor practice charges brought before the National Labor Relations Board (NLRB) has more than doubled, from below 10,000 each year in the 1960s, to above 20,000 each year in the 1980s. The percentage and number of valid cases has risen significantly. From 1946 to 1977, roughly 70 percent of cases were withdrawn or dismissed. For most of the 1980s, only 60 percent were so treated. The number of workers who win reinstatement to remedy being fired by unfair labor practices has gone from a few thousand in the 1950s to several thousand in the 1970s and 1980s; in 1980 and 1985, workers so reinstated numbered in the tens of thousands. The NLRB has been overwhelmed by these increases. The median length of time required to resolve unfair labor practice cases increased from just over 500 days in 1980 to slightly over 750 days by 1989.

Largely because of these attacks by American firms on collective bargaining, the U.S. has the lowest share of unionized workers of any democratic industrialized nations; also the U.S. had one of the greatest declines in union density during the 1980s.

So, in large part because of a domestic policy agenda that weakened U.S. worker rights and the dominance of international trade theory that assumes that wages reflect productivity, worker rights in trade issues have not been aggressively pursued. But, with new evidence on U.S. wage trends, and the lack of a relationship between wages and productivity in many less developed countries, it is time to rethink the role of worker rights in international trade.

LOW-WAGES OR LOW PRODUCTIVITY

Between 1985 and 1988, the U.S. balance of trade in manufactured goods deteriorated by $17.5 billion. In trade with the European Community, it actually improved. All of the decline in balance can be accounted for by Japan and the developing world. The growing gap in manufactured goods trade with Japan was equal to 64 percent of the total decline. But, the growing gap in manufactured goods trade with the developing world was equal to about eighty percent of the total decline. The trade imbalance with the developing world reflects the dramatic increase in manufactured imports by the U.S. from the developing world. Between 1980 and 1988, U.S. manufactured goods imports increased by 170 percent. From the European Community they increased by 134 percent, while from the developing world they increased by 240 percent. As examples, manufactured goods imports from Mexico increased by 296 percent, from Brazil by 338 percent, and from South Korea by 386 percent.

The wage gap between industrial workers in the U.S. and developing world are huge. Table 1 shows the wage gaps for six low wage countries. It also shows the fast growth in manufactured imports from those countries. These wage gaps, and the growing trade deficit with low-wage countries in manufactured goods prompts concern from America's labor leaders. But, international trade economists normally dismiss such concerns because their theory says that the low wages do not give those countries a competitive advantage.

But, the claim of international trade economists that the wages of workers reflect their productivity has no empirical basis. New research clearly challenges this faith with data that shows low wages do not necessarily mean low productivity. These works include Magnus Blomstrom and Edward Wolff (1989), Peter Hooper and Kathryn Larin (1989), Walter Russell Mead (1990), Peter Dorman (1990), and Harley Shaiken (1993). What this data supports is a need to understand the wage setting mechanism of different countries. To the extent that worker rights are related to wage levels and labor costs, they must he viewed as equally important to trade agreements as government subsidies, or intellectual property rights.

Table 1—Hourly Compensation Costs of Production Workers in Manufacturing, 6 Low-Wage Countries as a Percentage of U.S. Costs and Increase in U.S. Manufactured Imports from those Countries 1980–88

Country	Hourly compensation		Percent increase in U.S manufactured imports 1980–88
	1980	1988	
Brazil	14	10	338
Hong Kong	15	17	116
Korea	10	17	386
Mexico	30	9	296
Singapore	15	19	342
Taiwan	10	20	262
United States	100	100	.....

SOURCE: Walter Russell Mead, The Low-Wage Challenge to Global Growth (1990) Table 4; and, U.S Dep't of Labor, Bureau of Labor Statistics, Report 817, International Comparisons of Hourly Compensation Costs for Production Workers in Manufacturing, 1975-90 (1991), Table 1.

Combining the productivity work of Blomstrom and Wolff with wage data, Robert Blecker and I have shown (Blecker and Spriggs. 1992) that in the two manufacturing sectors that the U.S. has the largest trade deficits with Mexico, Mexican wages relative to U.S. wages do not reflect the ratio of Mexican to U.S. productivity. This is shown in the following table.

Table 2—Mexican Labor Productivity and Hourly Labor Compensation, as Ratios of the U.S. Levels, 1975–84

	1975	1979	1982	1984
Electronic equipment				
Productivity	0.63	0.74	0.66	0.83
Compensation	0.24	0.24	0.20	0.15
Transportation equipment.				
Productivity	0.53	0.61	0.59	0.57
Compensation	0.31	0.28	0.20	0.13

Source: Magnus Blomstrom and Edward N Wolf, "Multinational Corporations and Productivity Convergence in Mexico," National Bureau of Economic Research Working Paper No 3141 (Cambridge, MA October 1989). Table 8, page 25; U S Dept of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, Houly Compensation Costs for Production Workers, 40 Manufacturing Industries, 34 Countries, 1975 and 1979-80, Unpublished Data (September 1990) pages 86 and 95 Transportation compensation is for motor vehicle equipment. And, author's calculations

Note: Productivity is measured by value added per employee

Productivity is measured in Table 2 as value added per employee in each industry. The differential in worker compensation cost (wages plus mandated and negotiated benefits and taxes) in the two industries is also shown in the table. During the period shown. the relative cost of employing Mexican to U.S. workers was declining. In electronics, Mexican workers' wages fell from 24 to 15 percent of U.S. wages in that industry. In transportation equipment. Mexican workers went from 31 percent of U.S. wages down to 13 percent. Yet, in transportation equipment. Mexican workers were between 53 and 61 percent as productive as U.S. workers. In the electronics industry. the difference is even more stark. In electronics. Mexican workers went from 63 to 83 percent as productive as U.S. workers. Thus. the unit labor costs of production in Mexico in these industries are much lower than in the United States. These are not low-wage industries by U.S. standards. These are "high-tech" (electronics) and capital intensive (transportation equipment) industries, for which the traditional comparative advantage model would expect the U.S. to retain a cost advantage.

Shaiken (1993) has carefully studied automobile engine plants run by the same company, in Mexico and the U.S. midwest. The Mexican plant was built in 1983. Because the engine plants produce the same product with almost identical technologies, he is able to compare the physical output of the two plants. The Shaiken data supports the broader measure of productivity shown in Table 2. He was able to document that in less than two years, from 1984 to 1986, the Mexican facility was able to perform at 115 percent of the U.S. facility in making engine heads, and 94 percent in making engine blocks. Based on six years of data, from 1986 to 1991, on engine repairs reported from consumer surveys, the Mexican plant had higher quality than the U.S. plant in four of those six years.

Hooper and Larin studied unit labor costs in manufacturing because labor is such a large non-traded input into the manufacturing process. Their estimates are conservative since they use purchasing power parity indexes to convert currencies. So, their measure underestimates labor costs by emphasizing the purchasing power of workers wages. The use of market exchange rates would have emphasized the relative cost of production. Table 3 shows their results for the U.S. and Korea for 1980 to 1988. During that period, while U.S. labor costs were roughly constant, the Korean costs fell. This divergence in unit labor costs reflects a more rapid growth in productivity in Korea than in America. The result is that American firms were made less competitive relative to their Korean counterparts because Korean wages did not increase with Korean worker productivity.

Table 3—Manufacturing Unit Labor Costs (U.S. Dollar price per unit of Output)

Year	United States	Korea
1980	65.7	42.0
1981	70.8	36.6
1982	74.4	40.3
1983	73.1	41.4
1984	71.7	35.2
1985	71.2	31.5
1986	70.0	29.9
1987	69.0	32.0
1988	69.9	35.5

Source: Peter Hooper and Kathryn Larin, "International Comparisons of Labor Costs in Manufacturing," Review of Income and Wealth (December, 1989), Table 5

Citing a U.S. International Trade Commission study, Mead (1990) shows that Brazilian and Korean steel workers reach a productivity level that is roughly sixty percent of the U.S. level in cold rolled steel, but that they earn wages that are approximately ten percent of the U.S. level. This makes labor costs five times greater in the U.S. than in Korea or Brazil per metric ton of cold rolled steel.

Blecker (1992, p. 101-102) has explained why the trade theorists faith in the equality of wages and the value of the marginal productivity of labor misses reality.

> First, technology and capital are internationally mobile, enabling less developed countries to raise their productivity levels far above what their domestic technological capabilities alone would permit. Second, these countries suffer from what development economists have called "dualism" in labor markets. * * * That is, developing countries typically have a modern capitalist sector which uses advanced technology alongside a backward subsistence sector which uses traditional methods (sometimes called the "informal sector"). * * * This segmentation of labor markets implies that they are not perfectly competitive, and that wages do not freely adjust to equalize the total demand for labor with the supply in the modern sector where there is chronic excess supply. * * * [These countries] will have a persistent advantage in unit labor costs in a wide spectrum of manufacturing activities.

LOW-WAGES AND WORKERS RIGHTS

Dorman (1990, p. 7) measures, in a crude way, the relationship between worker rights and wages. He looked at ten countries, and ranked their worker rights along several dimensions. One measure was of the right to form unions, and was scaled from a score of one to four. A country with the highest rights would be scored a four. Dorinan also controlled for national unemployment rate, the literacy rate of the country, and the share of nonagricultural employment in the country. Increasing the amount of rights enough to go up the scale by one, increased the average wage of production workers in the sample by almost forty percent. Two other indexes of worker rights were more broad civil rights and liberties. They were scaled from five

to one. A country with the highest rights would be scored a one. Increasing the amount of civil rights enough to go down the scale by one, increased the average wage of production workers in the sample by a little over thirty percent.

Though his measures are admittedly crude, they are very instructive. An increase of thirty to forty percent in the wages of the countries shown in Table would close the unit labor cost advantage that those countries have in many industries. The extent to which countries are able to use limited worker rights to suppress workers receiving wages closer to their productivity grants them a competitive trade advantage.

That idea is not novel. In the U.S. domestic labor policy debates include references to America's competitive stance. Opponents of increasing American worker rights argue that new regulations will hurt America's competitiveness. Proponents of American labor rights have taken to showing how America's competitiveness will not be harmed by labor legislation through comparative analysis of industrialized country labor codes.

The differences in labor rights regimes across countries creates different market imperfections. If labor codes are not made uniform, the differences in worker rights can become a market imperfection that companies can exploit.

MULTINATIONAL CORPORATIONS AND WORKER RIGHTS

American workers are concerned with international labor rights because of the pressure on American wages that competition with low-wage producers can have. But American workers are also concerned with international worker rights because of the mobility of capital. American workers who must bid for jobs against workers who have fewer worker rights also feel competition.

The opening of world markets is growing faster than size of the world market. In the 1970s and 1980s international trade grew about twice as fast as world demand. Foreign direct investment grew almost three and a half times as fast as world demand. And much of the increase in trade was within industry trade (Preston and Windsor, 1992). The increase in within-industry trade is the result of increased foreign direct investment. Multinational firms clearly are driven by the search to exploit market imperfections.

Table 4 shows the annual growth rate of manufacturing imports from U.S. multinationals operating in Latin America and non-Japan Asia. This gives an indication of the competition that American manufacturing workers felt from those low-wage areas resulting from the mobility of international capital.

Table 4—Annual Growth Rate in U.S. Imports from Manufacturing, Non-bank U.S. Foreign Affiliates 1983-1989

	Percent	
	Latin America	Asia (Other than Japan)
All industries	9.0	14.4
Manufacturing	18.5	14.1
Food and kindred products	13.1	0.7
Grain mill and bakery products	41.4	NA
Chemicals and allied products	8.9	NA
Soap, cleaners, & toilet goods	69.8	12.2
Chemical products, nec	NA	3.4
Primary and fabricated metals	2.1	NA
Ferrous	3.8	NA
Machinery, except electrical	13.8	40.2
Computer & office equipment	NA	39.1
Electric & electronic equipment	11.4	3.8
Electronic components	NA	5.5
Tobacco products	8.4	NA
Textile products and appare	19.6	41.4
Lumber and furniture	46.5	NA
Paper and allied products	NA	97.3
Printing and publishing	NA	—20.6
Rubber products	NA	51.3
Stone, clay, and related prod	10.9	30.8
Instruments and related prod	60.5	NA

Table 4—Annual Growth Rate in U.S. Imports from Manufacturing, Non-bank U.S. Foreign Affiliates 1983-1989—Continued

	Percent	
	Latin America	Asia (Other than Japan)
Other	7.2	NA

Source: U.S Dept of Commerce, BEA, U.S. Direct Investment Abroad, 1989 Benchmark Survey, Preliminary Results IID (BE-SO) unpublished data on computer diskette. (November, 1991)

Calculations: William Spriggs and Thea Lee, Economic Policy Institute.

If worker rights are not emphasized more in American trade policy, then given current trends, American workers will continue to face growing pressures to limit their own rights. Domestic labor policy debates will continue to be dominated by concerns that American worker rights will make American companies less competitive. Just as market forces will tend to level international wage differences, bringing those with higher wages down (Leamer, 1992); so will political forces act to lower worker rights standards. But such a direction is not in the interest of world democracy; and the resulting low wages will not support sustained economic growth.

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Senator KERRY. Mr. Housman.

STATEMENT OF ROBERT F. HOUSMAN, STAFF ATTORNEY AND TRADE SPECIALIST, THE CENTER FOR INTERNATIONAL ENVIRONMENTAL LAW

Mr. HOUSMAN. Thank you Senator Kerry and Senator Hollings. My testimony today will focus on the interrelationship between U.S. economic and environmental interests, particularly in the trade arena. I am going to discuss the GATT and the Uruguay Round, the NAFTA, and the supplemental agreement on the environment, and finally the U.S. environmental technology industry.

As the United States tries to wake itself up out of a sleeping recessionary economy and move into a period of growth, it is somewhat obvious that trade and investment—international trade and investment—will play a major role. The GATT was created in 1947 at a time when a factory spewing out toxic fumes was viewed as a positive, good—it was something to be sought after. It was not an environmental indicator of harm.

Unfortunately, as you know, we have come to realize over time that there are a series of environmental concerns that need to be addressed, and we have developed a fairly sophisticated regulatory system in the United States to do so. The down side is that the GATT has not kept up with us. The GATT has failed to evolve in any way, shape, or form to take into account these environmental considerations. And the problems with the underlying GATT are only exacerbated by what is called the Dunkel text of the Uruguay Round, particularly the standards provisions of the GATT and Uruguay Round text.

While the environmental shortcomings of the GATT and the Uruguay Round text are readily apparent, I would argue that the effects of these shortcomings on U.S. industrial international competitiveness are more insidious but nonetheless substantial. As the rules of free trade gain stringency and enforcement powers, without environmental reform other nations will become able to bring still greater, more economically coercive pressure upon the United States to weaken our standards.

If we stand alone and maintain our standards, we run the risk of placing ourselves at a competitive disadvantage vis-a-vis other trading partners. However, if we give in to these pressures, if we succumb to them, we then run the risk of polluting our rivers, harming our citizens—all choices that I do not think this administration, nor this body, the Congress, are willing to accept, let alone whether the American public is willing to accept Love Canal or Three Mile Island all over again.

Also, this rush to harmonization that you mentioned, Senator Kerry, also poses dangers for the United States. Harmonization is a negotiation, and negotiations means you compromise. The United States has basically the highest standards around the globe. If we are harmonizing, if we are compromising our standards, we are going to be giving up something in the environmental arena potentially, and I think that is of concern.

However, on the flip side, if we stand alone here again we run the risk of placing ourselves at a competitive disadvantage.

Senator KERRY. Not just competitive but an environmental disadvantage. I would think in the sense that if we stand alone without getting people to agree to any regimen at all, they continue to do damage that has irreversible impact on us also.

Mr. HOUSMAN. That is precisely the point. And I think that that process is already occurring. I would point to the Economic Council of Europe's work in developing automobile emissions standards. The member countries from Europe are seeking to develop standards that are far lower than the U.S. auto emission standards.

The United States here will run several risks. One is we harmonize downward, we join their party, and our air becomes more polluted, so does theirs, and we do not have the level of standard of living that we had before in terms of air quality. For example, children develop lead poisoning from auto emissions. On the other end of the spectrum, if we stand alone what do we say to the U.S. automakers?

I think that both of these examples, the example of harmonization and the example of potential challenges to our environmental laws point out the need for the United States to take a proactive role in the international trade arena to develop a consensus for upward harmonization, to develop a consensus for international environmental protections and domestic environmental protections that work to our advantage competitively by leveling the playing field at a level that more accurately reflects the environmental need and is closer in nature to the level of protection we have in the United States. And I think my testimony lays out several proposals to that end.

I want to move on to the NAFTA because it is obviously on everybody's mind. The current negotiations of supplemental labor and environmental agreements I think provide an opportunity for the United States to advance not only the competitiveness of U.S. industries but environmental and labor protection throughout North America. I think this is a vital opportunity that should not be missed.

CIEL, my organization, strongly believes that a North American Commission on the Environment with real powers to, among other things, authorize a NAFTA party to bring trade measures to bear on another party that fails to enforce its own environmental standards—and I would add here that there is a parallel in the labor area—is an important development. We have looked at recent popular press accounts of the Clinton administration's enforcement proposal and while as Ross Perot says, "the devil is in the details," I think this is a heartening step forward by the administration to correct the flaws in what I would call the Bush agreement.

Recently, several Members of Congress have come out arguing to the administration that they should not adopt higher standards, environmental protections, that include trade measures in the NAFTA supplemental agreement.

I think the failure to promote trade measures not only would undercut our environmental protection, but also, given the pollution haven argument, would harm U.S. competitiveness. A recent study shows that companies operating without environmental standards can obtain profit margins in excess of 200 percent higher than their competitors who maintain full environmental standards. These

members that they should rethink their position in light of the fact that it is neither in our environmental interest nor competitiveness agreements to see these agreements not go forward—both the NAFTA underlying and the supplemental agreement.

I want to move very quickly to the environmental technology industry sector because I think this is an area that does not get enough attention. The envirotech industrial sector is perhaps the most striking example of how the U.S. environmental agenda comports with our goal of increased competitiveness internationally.

Every newly enacted environmental standard around the world provides a new market for American companies operating in this vibrant industrial sector. Thus leveling the environmental playing field upward to meet U.S. standards for trade, not only allows for fairer competition it also creates new arenas for competition.

I think here it is important to stress that there are a tremendous number of simple things that could help this sector. I am not talking about broad based industrial policies of subsidies and picking winners. I am talking about things like providing standard industrial codes so we have some markers of where we stand and where other countries stand. Currently there is no standard industrial codes for either environmental goods or environmental services. This is ridiculous and could be corrected in short order, at low cost, with very little intrusion into the market, and in complete compliance with all our trade obligations.

Here, again, in terms of how to promote the envirotech industrial sector, I think my testimony lays out several proposals that could do just that.

Finally because the earlier panels have dealt so heavily upon the structure of U.S. trade decisionmaking, and I think it is a very important area, an area that needs far greater coordination, I would refer the subcommittee to the testimony that I gave earlier this year before the House Merchant Marine and Fisheries Committee which dealt specifically with methods of improving U.S. trade decisionmaking, particularly in the environmental area but more broadly as well.

In a recent report entitled, a "Trade Policy for a More Competitive America," the Trade Policy Subcouncil, the congressionally chartered Competitiveness Policy Council—so these are not environmental maniacs—stated, "the goals of freer trade and environmental protection can very often be coexistent and mutually reinforcing."

I think this statement is totally correct. In fact, I think it is too modest. I think that in order for us to move forward we need to have mutually reinforcing environmental and economic policies. I think coordination through the NEC and through the USTR's office, and greater cooperation with EPA and other agencies is an important first step.

I would also point out that this report recognizes something else that I think bears repeating. We place a lot of worth on trade policy in terms of competitiveness, but this report points out that trade will not alone guarantee the competitiveness of the United States. Much of trade's ability to encourage competitiveness will be dependent upon our ability to integrate other policy goals, other policy areas like the environment and labor into our trade policy

making so that we develop an overall economic strategy that reflects all of our goals and moves forward on all of our agendas.

I think if we are able to do this, trade and the environment—and trade and labor—as well gives us an important opportunity not only to reap substantial economic benefits, but I think also to do good things. This is something we do not often have the chance to do. We would be foolish to squander the opportunities that are before us now in the GATT and NAFTA and in developing new industrial sectors as well.

Thank you.

[The prepared statement of Mr. Housman follows:]

PREPARED STATEMENT OF ROBERT F. HOUSMAN

Chairman Kerry, members of the Subcommittee, thank you for the opportunity to appear before you to testify on issues affecting United States competitiveness in a global economy.

My name is Robert F. Housman. I am a Staff Attorney and Trade Specialist with the Center for International Environmental Law (CIEL) and an Adjunct Professor of Law at the American University's Washington College of Law.

The topic of today's hearing—issues affecting United States competitiveness in a global economy—is a most timely one. Consider that the Clinton Administration has recently requested an extension of fast-track negotiating authority to complete the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), and that the United States is also involved in negotiations with our North American Free Trade Agreement (NAFTA) partners to develop supplemental environmental and labor agreements. We are also confronted with growing trade imbalances with a number of our trading partners that point to serious flaws in the manner in which we, the United States, are doing business in international markets.

My testimony today will focus on the inter-relationship between United States economic and environmental interests, particularly in the trade arena. While my comments focus on the inter-play between economic and environmental policies and United States competitiveness, many of the concerns raised in this context are indicative of broader concerns that exist with regard to the general competitiveness of the United States internationally. I will discuss in turn, GATT and the text now being negotiated in the Uruguay Round, NAFTA and the supplemental environmental agreement, and finally the development of the United States environmental technology (envirotech) industry.

Each of these focal areas—GATT, NAFTA, and the development of the United States envirotech industry-offer important opportunities to develop a model of econonic development CIEL calls "competitive sustainability." For a complete treatment of competitive sustainability see appendix A to this testimony. Competitive sustainability, defines a mechanism for realizing sustainable development through "upward harmonization of domestic and international environmental, health and safety standards, using competitive forces to create a level playing field for commerce at consistently higher levels of environmental and social protections that reward the cleanest and most efficient economic actors for their efforts. The goal here is not to over-burden economic activities, but to put them to work for the environment, health and safety. By focusing economic activities, through incentives and disincentives, in directions that yield both economic and environmental benefits, these economic activities can become engines to drive standards of living-broadly defined to include economic, environmental, social, and health stability and security-upwards. Unfortunately, the timeframe for acting on these opportunities is short. The United States must act quickly to develop mutually reinforcing global competitiveness policies-read trade and associated policies-and environmental policies.

GATT

As the United States seeks to wake its sleeping economy out of a recession slumber, international trade and investment is an important stimulant for our economic growth. In 1991, by the most conservative estimates, global trade in merchandise and services accounted for approximately $4.38 trillion. GATT is the principal instrument of global trade and thus ii presents a critical opportunity to advance not only growth, but ultimately competitive sustainability.

GATT was created in 1947, before global environmental concerns existed. In 1947, a factory smokestack spewing toxic air emissions was a sign of economic progress

not a warning of ecological demise. Since GATT's creation, our understanding of the environment has increased markedly. Unfortunately, GATT has failed to evolve to meet the environmental challenges we all now face. In fact, recent developments within GATT have made the agreement even more hostile to environmental concerns than the original text. For example, recent GATT jurisprudence has significantly narrowed the leeway the Contracting Parties have to adopt environmental measures under the agreement's article 20 exceptions. Similarly, GATT jurisprudence also now provides that a country cannot restrict the market access a good enjoys based upon the production process methods used in producing the good-a widget is a widget regardless of how many people might be killed or poisoned in making it. As environmental policy leeway has narrowed, other GATT Parties are betting in line to challenge American environmental protection laws, including our corporate average fuel economy (CAFE) standards, and the "gas guzzler tax." Furthermore, GATT decision-making and dispute resolution fails to provide the public-the most important institution in environmental protection-with democratic participatory rights in its affairs.

These concerns are exacerbated by the draft final Uruguay Round text known as the "Dunkel text." The Dunkel text would lock in existing GATT jurisprudence, as well as strengthening a number of GATT's standards provisions (including both sanitary and phytosanitary (S&P) and technical barriers to trade (TBT) sections) that could be used to undercut many United Stales environmental protections-protections ranging from the Delaney Clauses to export rules now being discussed to preserve our ancient forests in the Pacific Northwest. Additionally, the Dunkel text would strengthen GATT's ability to coerce parties found in violation of GATT's rules to change their laws and practices to come into compliance with these rules. The Dunkel text would also create a Multilateral Trade Organization (MTO), with substantial powers of its own to encourage compliance with GATT rules that fail to take environmental concerns sufficiently into account. Finally, the Dunkel Text does nothing to address the lack of democratic participation in international trade decision-making; its efforts to strengthen the insular and secretive GATT serve only to further remove the citizens of the GATT Contracting Parties from making the institutions of trade publicly accountable.

While the environmental shortcomings of the Uruguay Round are readily apparent, the effects of these shortcomings on United States international competitiveness are more insidious, but nonetheless substantial. With few exceptions, the United States has served as the world's leader in environmental protection. While our system is far from perfect, our environmental laws are the most sophisticated in all the world, and no other nation can equal the United States record on enforcing even their own less stringent environmental laws. Over the course of the past twenty-five years the United States has repeatedly resisted the pressures of other nations to weaken our environmental, health and safety standards.

However, as the rules of free trade gain stringency and enforcement powers, without environmental reform, other nations will become able to bring still greater, more economically coercive pressures to bear on the United States to weaken our standards. If the United States refuses to yield to the call of other nations to adopt lowest common denominator environmental, health or safety standards, our standards will then be exposed to the threat of international trade challenges. If these challenges prove successful, the United States will be left with a most untenable choice, either compromise the quality of the environment and the safety of its citizens or stand alone, risking potential trade retaliations and putting domestic industries at tremendous competitive disadvantages vis-a-vis foreign competitors.

Moreover, the international emphasis on the avoidance of trade conflicts through the development of "harmonized" standards also stands as a significant threat to United States economic and environmental interests. As nations rush forward in pursuit of greater economic integration and trade-driven growth, there is a strong impetus to harmonize downward to lower international environmental, health, and safety standards. Unless the United States agrees to compromise its protections, United States industries will be forced to compete against foreign industries that fail to internalize their environmental costs and benefit from easier international market access for their products.

This scenario is not mere conjecture; this process is already occurring. Under the auspices of the Economic Council of Europe, the nations of Europe are negotiating international auto emission standards; standards that, as currently contemplated, would be far less stringent than those under United States law. If the European nations come to agreement on these lower emissions standards, the United States will be faced with either putting its automakers in a competitive hole, or increasing the environmental, health and safety risks that United States citizens are exposed

to—an option that neither the United States Congress, nor the American public, will endorse.

The moment is at hand for the United States to exercise leadership in the international trade and environment arena to secure both its economic and environmental interests. First and foremost, the United States must ensure that, at minimum, the Uruguay Round does not harm concurrent United States economic and environmental interests. Thus, the standards sections of the Uruguay Round must be changed to provide greater protection to environmental standards. To achieve this goal the Uruguay Round should adopt the standards provisions of NAFTA with the clarifications requested by the environmental community. See appendix B. The Uruguay Round must also ensure greater public participation and transparency in GATT decision-making and dispute resolution.

Additionally, the Uruguay Round must also provide for a commitment from the GATT parties to immediately begin negotiations to "green" GATT. Existing negotiations concerning the MTO and procedural changes to GATT should be carried over and presented in final form as a package with the results of the environmental negotiation for approval of the Contracting Parties. Tying the MTO and procedural negotiations to the environmental negotiations ensures that three ends, each of vital concern to the United States, are addressed. First, significant Constitutional and public policy concerns have been raised with regard to the structure and powers of the MTO as currently proposed. Second, placing the MTO and structural changes within a second tied negotiation allows for a more considered look at the proposed changes. Although, the MTO has been "on the table" since the beginning of the Round, it was not until the Dunkel Text included it in its provisions that serious attention has been paid to the ramifications of the MTO as proposed. After almost seven years of debate, it would be ill advised to now hastily agree to the fundamental structural changes proposed just to close the Round. Third, if properly conceived, the structural changes to GATT will be vital to the interests of the Contracting Parties; placing them as part of a "package deal" with environmental reform would provide the Contracting Parties with the incentive to vigorously negotiate these agreements without delay. To achieve the goal of a speedy and successful end to these negotiations the Uruguay Round commitment from the Parties should set forth a series of timetables for these parallel negotiations.

NAFTA

The current negotiations on the creation of supplemental labor and environmental agreements to NAFTA also provide an opportunity for the United States to advance the competitiveness of American industries while simultaneously increasing the protection of the North American environment. CIEL strongly believes that a North American Commission on the Environment (NACE) with real powers to inter alia authorize a NAFTA party to use trade sanctions to address another NAFTA party's failure to enforce its domestic environmental laws, advances both our economic and environmental interests. While we have yet to see the details of the Clinton Administration's proposal, we are heartened by press accounts discussing the proposal's reliance on such trade measures as an environmental enforcement tool. We look forward to working with the Administration in further developing its proposal.

Recently, certain members of the Congress have called upon the Clinton Administration to refrain from allowing trade measures to be used to address lax environmental enforcement in a NAFTA supplemental accord. It is our strong hope that these members take a close look at the Administration's enforcement proposals and judge them on their efficacy at promoting the environmental and economic interests of the United States. In judging these proposals we feel it is imperative to bear in mind several critical facts. First, absent some mechanism to encourage all NAFTA parties to enforce their environmental laws, it is likely that imbalances in environmental enforcement will continue, if not worsen in certain instances. These imbalances will seriously hinder the ability of law-abiding American companies to compete with foreign competitors acting with disregard for both the environment and the rule of law. Second as discussed in greater detail below, strong enforcement of environmental laws increases the market for United States envirotech products and services, one of the most promising sectors of the United States economy. Third, absent changes in the enforcement policies of the NAFTA parties, increased NAFTA-driven growth is likely to come at the expense of human health and safety, and the integrity of our environment. These real costs can be measured in the quality of our air, water, land and health, particularly in the United States-Mexico border region.

Opponents of strong NAFTA supplemental agreements argue that these agreements come at the risk of over-burdening the underlying NAFTA to the extent that it may collapse. While this concern is a valid one, we believe that the United States

negotiators, under the skilled guidance of Ambassadors Kantor and Yerxa, Administrator Browner, and the other agencies involved, have the experience and expertise to avoid this fate for NAFTA. Moreover, we have faith in our Mexican and Canadian partners, that having seen the benefits that will accrue to them not only from NAFTA, but from strong environmental and labor agreements as well, they will also ensure that NAFTA and the supplemental agreements will be implemented.

A successful NAFTA will serve as a model for the integration of environmental concerns into international trade policy—an integration that will advance both environmental protection and the competitiveness of United States industries which already compete under the most demanding environmental regulatory regime existing. This assumes that the final NAFTA package provides for an effective NACE with real powers to encourage each party to enforce its domestic laws, grants the public democratic rights in trade and environment decision-making and dispute resolution, provides a secure and adequate source of funding for NAFTA related environmental programs and projects, clarifies the ambiguities in the standards sections, ensures that polluters bear the costs of their environmentally degrading actions, and provides greater protection to international environmental agreements. A truly environmentally sound NAFTA will be the benchmark for all future trade agreements. This is an opportunity that we cannot allow ourselves to squander.

ENVIROTECH

The envirotech industrial sector is, perhaps, the most striking example of how the United States' environmental agenda comports with our goal of increased United States international competitiveness. Every newly enacted environmental standard around the world provides a new market for American companies operating in this vibrant industrial sector. Thus, levelling the environmental playing field upward to meet United States standards for trade not only allows for more fair competition it also creates new arenas for competition.

Unfortunately, the United States envirotech market share is eroding, in large measure because other countries, particularly Germany and Japan, who have industrial policies, have identified this sector as promising, and are actively promoting their domestic industries. The United States can work to regain its market share first by promoting the development of environmental standards that are as stringent as its own in every fora and at every opportunity. In addition the simple step of providing Standard Industrial Codes for envirotech products and services will also assist the United States in gauging and enhancing its competitiveness in this sector. Finally, the United States can assist both environmental protection and the growth of this industrial sector through cooperative programs, such as those being advanced by Congressman Gerry Studds, designed to make United States expertise, technologies and services more readily available on global markets.

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In a recent report entitled "A Trade Policy For a More Competitive America," the Trade Policy Subcouncil of the Congressionally chartered Competitiveness Policy Council stated "[t]he goals of freer trade and environmental protection can very often be coexistent and mutually reinforcing." This statement is entirely correct, but it is all too modest. The goals of increased United States competitiveness and environmental protection can very often be coexistent; in order to secure the future of both United States economic and environmental interests these policies must, wherever possible, be consciously designed by Congress and the Administration to be mutually supportive. In its recommendations the Trade Policy Subcouncil advocated "the United States adopt a more constructive and progressive stance on the intersection between trade and the environment in international fora and aggressively work to see that our trading partners do so as well, particularly in a post-Uruguay Round multilateral trade negotiation." Similarly, the Environmental Protection Agency's Trade and Environment Committee of the National Advisory Council on Environmental Policy and Technology has for some time now emphasized the "positive synergy" between trade and environment concerns: trade can advance environmental protection and environmental protection can open new markets for trade. Advice as sound as this should not be overlooked.

The first step in this endeavor is the creation domestically of a culture of cooperation between advocates of increased competitiveness and free trade and advocates of environmental protection. Both sides must come to recognize that they are more compatriots than opponents. They must then work together to craft a United States agenda that raises the real standard of living of all Americans. The standard of living I refer to here reflects not only the ability to have a job and to support one's family, but also to be safe in the knowledge that the food on our tables, the water we drink and the air we breath are safe and clean. We must then take this agenda

to the world; through international and regional trade agreements, technology cooperation, educational efforts, and the development of environmental standards as floors and not ceilings we can forge an economic development model that is environmentally sustainable. Such a model would clearly benefit the United States and our trading partners.

The interplay between United States competitiveness and environmental protection offers this country the unique opportunity to reap huge economic benefits, while simultaneously advancing the critical goal of global environmental, health, and safety protection. Thank you.

[Appendix A—"Making Trade and Environmental Policies Mutually Reinforcing: Forging Competitive Sustainability," by Robert F. Housman and Durwood J. Zaelke may be found in the committee files.]

LETTER FROM DEFENDERS OF WILDLIFE, CENTER FOR INTERNATIONAL ENVIRONMENTAL LAW (CIEL), FRIENDS OF THE EARTH, SIERRA CLUB, PUBLIC CITIZEN, THE HUMANE SOCIETY OF THE UNITED STATES, HUMANE SOCIETY INTERNATIONAL, INSTITUTE FOR AGRICULTURE AND TRADE POLICY, CENTER FOR RURAL AFFAIRS, NATIONAL FAMILY FARM COALITION, EARTH ISLAND INSTITUTE, MARINE MAMMAL FUND, ANIMAL PROTECTION INSTITUTE, RAINFOREST ACTION NETWORK, WHALE AND DOLPHIN CONSERVATION SOCIETY, PERFORMING ANIMAL WELFARE SOCIETY (PAWS), THE FUND FOR ANIMALS, ENVIRONMENTAL INVESTIGATION SOCIETY, ENVIRONMENTAL SOLUTIONS INTERNATIONAL, INTERNATIONAL PRIMATE PROTECTION LEAGUE, N.Y. PUBLIC INTEREST RESEARCH GROUP, INC., COMMUNITY NUTRITION INSTITUTE, NATIONAL TOXICS CAMPAIGN FUND, NORTH AMERICA PROJECT, WORLD POLICY INSTITUTE, AND GREENPEACE, U.S.

MARCH 4, 1993.

The Hon. MICKEY KANTOR,
U.S. Trade Representative,
Washington, DC 20506

DEAR AMBASSADOR KANTOR: As we all acknowledged on February 23, 1993, during a meeting with you, a number of environmental, conservation, health, and safety problems remain in the present NAFTA. We, the undersigned, hope that this letter clarifies the position of our groups with respect to the President Clinton's NAFTA package. Successful resolution of these problems would not only promote sustainable hemispheric trade, but would also send a clear message to the Uruguay Round negotiators in Geneva. While all the groups signed to this letter acknowledge the NAFTA problems identified, individual groups reserve the right to offer varying solutions to these problems.

First and foremost, we support the President's call for an "environmental" supplemental agreement that will establish a strong North American Commission on the Environment (NACE). However, such a supplemental agreement -must clarify various other provisions of the existing NAFTA. In our opinion, these elements of a supplemental agreement should be in the form of a protocol, legally binding upon any party to NAFTA, and of equal stature to NAFTA. Some groups have drafted protocol language for the NACE and are presently drafting similar language for the protocol's other provisions that will be forwarded to you shortly.

ENFORCENENT

Trade should not be based on weak enforcement of established standards. Enforcement is a crucial issue. We should not subject U.S. citizens to economic, health, safety, or environmental injury as a result of weak enforcement of standards elsewhere. Nor should our NAFTA partners be harmed by a failure of U.S. enforcement. Sanctions, including both trade and non-trade measures, must be available to ensure compliance. Recognizing that sovereignty concerns exist, we propose that a trilateral mechanism, the North American Commission on the Environment (NACE), as discussed below, be established with sufficient powers to ensure adequate enforcement of existing and future laws.

NAFTA ENVIRONMENTAL OMISSIONS AND AMBIGUITIES

We recognize the President's desire not to reopen the NAFTA text. Yet, there are provisions in the present text that are either contradictory or unclear, and work to the detriment of environmental, conservation, health, and safety protection. The Bush NAFTA also completely fails to address several important concerns. Therefore,

the topics listed below are areas where a NAFTA protocol must rectify present NAFTA omissions or ambiguities.

Environmental Remediation

Despite the fact that the several border agreements between the NAFTA parties have been considered separate from the present NAFTA we do not believe that NAFTA should go forward until enforceable commitments have been made to clean up the border regions. Estimates for the U.S.-Mexico border clean-up range from $ 5 to 15 billion. The U.S.-Canada border also suffers from trade induced problems.

Funding

A secure source of funding for proper infrastructure development, environmental enforcement, increased investigation, and clean-up for all NAFTA-related environmental programs is vital. Because national appropriations processes do not provide a secure source of funding, we believe that designated funding sources, based on fairness and the "polluter pays" principle, must be developed as a prereguisite to implementation of NAFTA.

Ideas that deserve attention include: a) "snap-back" tariffs applied to sectors with lax enforcement of existing standards; b) a small transaction fee on all goods and services that could be phased out over a specified number of years; c) a directed "green" fee; d) an environmental countervailing duty on economic activity that is environmentally unsusustainable or below standard; e) "earmarked" tariffs, which could be phased out during the first 10-15 years of NAFTA; and f) development of a "green investment bank," which could utilize established trust funds to leverage additional money through bond proposals. Regardless of which funding scheme(s) is eventually utilized, we believe it is imperative to channel such funds back into environmental infrastructure improvements, enforcement, border inspection, worker transition programs, certain farmer support programs, and funding of the NACE itself.

Public Participation and Transparency

Public accountability of governing bodies is an essential element of environmental protection and democratic governance. Accountability includes the rights of notice, comment, the opportunity to participate, the ability to bring complaints, and access to decision-making processes. For the NAFTA package to address these serious concerns, the process of crafting this protocol must provide public accountability and the protocol itself must ensure accountability in the administration and implementation of the NAFTA package.

The current NAFTA dispute panel provisions completely fail to provide citizens from the NAFTA countries with the means to obtain information from, and participate in, resolution of trade disputes concerning environmental, conservation, health, and safety matters. The protocol must provide the public with participatory rights in whatever forum ultimately resolves trade/environment disputes under NAFTA. Furthermore, the NAFTA package must ensure that the public can participate meaningfully in the remaining negotiations of NAFTA. Prior NAFTA negotiations failed to provide the public with sufficient participatory rights, resulting in the deficiencies outlined in this letter. The upcoming negotiations of the NAFTA supplemental agreements provide an ideal opportunity toe at least in part, rectify NAFTA's failure to embrace democratic principles.

International and Domestic Production/Process (PPM) Standards

Trade law must recognize that how a product is produced is as important as the quality of the product itself. Only by recognizing process-based trade restrictions will governments retain their ability to keep high domestic standards without placing domestic producers at a competitive disadvantage. Although Article XX of the General Agreement on Tariffs and Trade (GATT) provides for health and natural resource- conservation exceptions, these provisions have been constricted by recent GATT panel decisions. Without explicit clarification, NAFTA will repeat the mistake of GATT panels and the Dunkel draft by incorporating unacceptable provisions or interpretations of GATT (e.g., Article 103, NAFTA). For example, laws that would restrict the import of products made with CFCs, timber produced in an unsustainable fashion, or the inhumane treatment of animals could be subject to challenge under NAFTA.

The infamous tuna/dolphin dispute highlights the political difficulties that can be involved in a dispute. concerning production process issues. In the tuna/dolphin case, a GATT panel held that harvesting methods were not a GATT-legitimate basis for distinguishing between, and placing import restrictions on, dolphin deadly tuna. After considerable political negotiation, Mexico agreed to join the U.S. in a global moratorium on the setting of nets on dolphin and to use the moratorium as a basis

for prohibiting imports of dolphin deadly tuna. To date, Mexico and the U.S. have failed to enter into a global moratorium. The failure of such agreement to be effectively implemented serves to underscore the necessity for specific text within the context of the NAFTA package setting forth the right of NAFTA parties to set standards and distinguish between products on the basis of production methods. As part of the NAFTA package, we believe that relevant NAFTA parties should also be required to enter into and enact the global moratorium.

Standards

A formal trading relationship between countries with significantly different environmental standards possesses predictable tensions. On the one hand, a country with high standards does not want its environmental duality or economic competitiveness to suffer as a result of weak (or non-existent) standards elsewhere. On the other hand, a country with lower standards does not want its sovereignty infringed upon by other countries. No NAFTA party's environmental, health, or safety standards should be weakened by NAFTA, and the NAFTA package should encourage, rather than inhibit, the ability of any NAFTA party to raise standards. See H. Cong. Res. 246 (Waxman-Gephardt); Trade Act of 1974, as amended, 19 U.S.C. Section 2504. In addition, the protocol must protect the full jurisdictional range of each party's domestic standard setting ability, such as proposals to prevent the export of domestically prohibited or restricted products (e.g., pesticides).

We believe the difficulty in reconciling differences in standards can be resolved in a manner consistent with the fundamental principles of international trade; namely, the test for environmental, conservation, health, and safety standards should be the same as for other NAFTA provisions—national treatment and non-discrimination. NAFTA's standards provisions must not provide a mechanism to challenge another country's chosen level of environmental, conservation, health, or safety-protection, nor the means chosen to achieve such protection if the means is facially non-discriminatory in intent.

NAFTA's two chapters specifically covering standards, Sanitary and Phytosanitary standards (SPS) and Technical Barriers to Trade (TBT), contain ambiguous and contradictory language, and may be interpreted to encourage harmonization towards generally lower international norms. The current TBT and SPS texts set up numerous committees with broad policy jurisdiction, and establish detailed procedures for "conformity assessment" and other harmonization mechanisms. We believe that standard-setting is a matter for local, state, and national democratic bodies, and should be subject to trade disciplines only when there exists a discriminatory intent. To the extent that such committees and standard-setting procedures will exist in NAFTA, the SPS and TBT texts must be supplemented and clarified to ensure openness, mechanisms for public participation and oversight, and participation of environmental, health, and safety experts.

The protocol must also assure that the role of "science" as a necessary basis for standards-setting is not an absolute prerequisite to the adoption and implementation-of standards. Standards based, for instance, on the precautionary principle or on consumer preference must be allowed, so long as their intent is transparent and facially non-discriminatory. Similarly, standards not based on risk assessment, like referendums and "zero-risk" standards, must not be challengeable by NAFTA. The NAFTA package must also make clear the ability of countries to maintain more than one level of acceptable risk. Further, the role of international standard-setting bodies must be only advisory.

In addition, the NAFTA standards sections threaten to expose legitimate environmental, conservation, health, and safety protections to attack as trade barriers on the basis of how a particular level of protection is implemented. The protocol, therefore, must clarify that a non-discriminatory measure will not be held to violate NAFTA because some less NAFTA-inconsistent measure may conceptually exist, a measure has extrajurisdictional implications, or is based on process. distinctions.

Finally, the protections afforded by the-wide range of standards applicable in the NAFTA parties can only be as strong as the commitment of the NAFTA countries to effectively monitor, Inspect, and enforce these standards. For example, with the Increased movement of products expected from NAFTA, the U.S. will need to implement new inspection mechanisms to ensure that meat and livestock imported from Mexico and Canada meet all applicable U.S. standards.

Impact on State and Local Laws

Because states and localities are not parties to NAFTA, they cannot directly defend their standards under Chapter 7 or 9. Although the federal government is allowed to set standards it deems "appropriate," states and localities do not explicitly possess this right, and are thus dependent upon the federal government for defense.

Furthermore, NAFTA Article 105 states all parties "shall ensure that all necessary measures are taken that in order to give effect to the provisions of this agreement * * * by state and local governments." This situation will have a chilling effect upon progressive sub-federal legislation that often drives effective federal action. Thus, the NAFTA package must provide sub-federal governments standing and a major role in NAFTA disputes. It must also assure the ability of sub-federal governments to establish initiatives that exceed federal and international standards.

Investment

Although Article 1114 of the existing NAFTA recognizes "that it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures," it does nothing to actually prevent such an occurrence. No NAFTA country should become a "pollution haven" for unscrupulous investors, American or otherwise. The United States, for example, frequently applies limitations to investment, domestically and abroad, for important political and national security reasons; that definition must now be broadened to include ecological security. The NAFTA package must provide a means, including for instance offsetting tariffs to make "polluters pay," so that environmental, health, and safety costs are fully internalized. Moreover, NAFTA's investment provisions should permit access to dispute settlement as a means of preventing environmentally damaging investment.

International Agreements

At present, only three multilateral environmental agreements are given some limited measure of protection under NAFTA: CITES, the Montreal Protocol, and the Basel Convention. The Bush Administration's defense to this limitation was that only these three agreements-possess direct trade implications. Not only is this assertion false, but the logic behind the argument is also needlessly narrow. We strongly believe that all NAFTA parties must possess the ability to implement and enforce any international agreement by imposing trade restrictions, if such restrictions are an effective way to secure complete compliance with the agreement in question. Therefore, we believe all present and future international environmental, health, safety, animal welfare or conservation agreements, to which any NAFTA party is a signatory, should be referenced in the protocol and added to Article 104.

Energy

Rules of energy trade among NAFTA parties must respond to the pressing ecological imperative of global warming by assuring the stabilization of greenhouse gas emissions and the reduction of CO_2 emissions. For both Canada and the U.S., substantial reductions of the energy intensity of these economies is also required. It is critical that the protocol make these goals explicit. As currently written, Chapter 6 of NAFTA and its precursor in the U.S. -Canadian FTA fundamentally undermine these objectives. Particularly problematic are those provisions of NAFTA that provide for proportional access, as well as the subsidization of oil and gas projects.

Thus, the protocol must secure the right of all NAFTA parties to restrict the export of energy and energy resources to abate global climate change and achieve other environmental objectives. The protocol must also protect least-cost energy programs, like subsidies to encourage conservation and renewables, from trade challenges. In addition, the protocol should include specific provisions to encourage the transfer of appropriate energy efficient technology and to ensure that full environmental impact assessments are undertaken for all major energy projects.

Agriculture

NAFTA, as written, threatens the survival of family farmers who have the most experience and potential to be good stewards of the land. If agricultural production is to be put on a sustainable footing, (e.g. decreased production on marginal land and the use of fewer chemicals), then environmental and social costs must be internalized. This will not happen if family farmers have to compete with cheaper imports produced in less sustainable ways.

NAFTA must preserve the capacity to employ supply management as a policy tool to promote sustainability. This capacity has been seriously undermined by NAFTA's tariffication of quantitative import controls, including Section 22 of the Agricultural Adjustment Act and the Meat Import Act. We therefore propose that the tariffication provision be altered through the supplemental agreement to allow for import controls on supply managed crops and to create the possibility for the future supply management of crops not currently in the program.

Conservation Issues

The NAFTA package must not allow or encourage natural resources such as water, forests, and the diversity of species to be unsustainably consumed or harmed.

If countries are to develop and implement sustainable natural resource management programs, they must possess unfettered authority to regulate resource extraction. Of critical importance is the power to determine whether, and under what terms, a NAFTA party's resources may be exploited for export markets. Under NAFTA, particularly Articles 309 and 316, the sovereignty of countries to regulate the export of natural resources is severely curtailed. In fact, Article 316 goes much further than GATT by assuring perpetual access to other party's resources, notwithstanding domestic shortages, for as long as those resources last. A particularly serious problem in this regard is the prospect that NAFTA could be used to compel major interbasin transfers of water despite existing water management regimes. The protocol, thus, must explicitly provide that all parties possess unfettered authority to embargo natural resource exports for legitimate conservation ends.

A related problem centers upon the impact of NAFTA's intellectual property framework on efforts to protect the biological diversity of this continent's ecosystems. The protocol should ensure that equal -protection be afforded to both the "stewards" or"owners" of biological resources, including indigenous and minority peoples, as well as to patent holders.

To help deal with wildlife habitat conservation in particular, we propose that the Convention on Nature Protection and Wildlife Preservation in the Western Hemisphere be revitalized and specifically linked to NAFTA so that acceding countries to NAFTA make specific accommodations to habitat protection within their borders.

Government Procurement

The use of preferential purchasing policies is an important tool that has been used by governments at all levels to create markets for, and encourage the development of, green technology and environmentally sound products. Under Chapter 10 of NAFTA, such green procurement initiatives are vulnerable to challenge. For instance, under the CUSFTA, Canadian paper manufacturers have argued they possess a trade claim on the basis of recycled paper content requirements by U.S. governments. Thus, the protocol must assure the rights of governments to implement environmental purchasing policies and practices free from the threat of trade sanctions.

The "Necessary" Test and Other Problematic NAFTA Language

Like many other NAFTA provisions, Chapter 21's environmental "exceptions" incorporate GATT terminology and jurisprudence. Unfortunately, recent GATT panel decisions have interpreted the term "necessary to protect human, animal or plant life or health" as requiring "necessary" measures to be "least-GATT" or "least-trade" restrictive. Under this standard, many present federal and state measures could be found to be NAFTA-inconsistent—from bans on the trade in elephant ivory to state recycling programs. The environmental exceptions in NAFTA, therefore, need to be clarified and strengthened to ensure that the GATT jurisprudence does not affect the interpretation of NAFTA.

Also potentially problematic is NAFTA Article 903, which could be read to incorporate GATT provisions and jurisprudence in a way that diminishes a NAFTA country's ability to protect environmental resources. Furthermore, Annex 2004's allowance to seek dispute settlement if a party feels "any benefit it could reasonably have expected to accrue it * * * is being nullified or impaired" invites attack upon U.S. standards. Similarly, the "based on" language of Articles 754, 755, 757, and 905 could needlessly threatens U.S. laws like the Delaney clauses. Here again, a clarifying standard should be adopted in the protocol that protects all U.S. environmental, health, and safety standards, as long as they are not arbitrary, discriminatory, or disguised trade barriers.

Sustainable Development

While we laud the goal of "sustain-able development" in NAFTA's preamble, we would like to see the goal of sustainable development made binding, and appear in Article 102's Objectives. By truly integrating the concept of sustainability into this protocol, the NAFTA parties will establish an environmental benchmark for hemispheric trade and development.

THE NORTH AMERICAN COMMISSION ON TEE ENVIRONMENT (NACE)

We support a NACE that will possess investigative, monitoring, and enforcement powers for all present and future parties of NAFTA, as well as serve as a mechanism for meaningful public participation. A strong NACE would not only enable the NAFTA parties to jointly increase the use and implementation of beneficial environmental health, and safety measures, but also provide an effective mechanism for identifying and-addressing degrading activities that create unfair competitive ad-

vantages or result in trade distortions. All activities of the NACE described will be public, except where explicitly provided otherwise.

Structure of the NACE

Following are some practical recommendations regarding the structure and functions of the NACE.

NACE Commission

The Commission should ultimately be responsible for all functions of the NACE. Each NAFTA party should have the right to appoint one NACE Commissioner who, together with the other NACE Commissioners, will possess authority to effectively implement NACE policies and perform NACE functions. We suggest that the operative voting norm for NACE be a majority. The U.S. NACE Commissioner, equipped with a staff, should be selected-by the President with Senate confirmation.

NACE Secretariat

A permanent and independent Secretariat should also be created in order to realize NACE's substantial mandate. Thus, we recommend establishing a head of the Secretariat (Secretary General). The Secretary General, with staff, should possess responsibility for implementing the environmental, health and safety provisions of the NAFTA package, though national courts would retain concurrent jurisdiction to enforce standards in-their own courts. The Secretariat should also be responsible for submitting an annual public report to the parties on its various duties.

Roster of Dispute Panelists

The Commission should establish a roster of environmental, conservation, health, and safety experts with appropriate trade background for dispute resolution under NACE.

NACE Public Advisory Committee

We suggest a Public Advisory Committee be formed, made up of four representatives from each country and one representative selected by the Secretariat. The four U.S. representatives should be picked by the President, and must include at least two individuals from non-profit environmental, conservation, health, and safety groups.

Functions of the NACE

Dispute settlement

An effective NACE must be empowered with the authority to engage in two distinct.prongs of dispute resolution:

NACE must be able to effectively dismiss complaints that attack laws whose sole purpose is to advance legitimate environmental, health, safety, or conservation laws. The protocol should provide that challenges to laws implicating environmental, health, and safety protections should be referred to the NACE. Where the NACE finds that the sole purpose and effect of a challenged party's measure is to advance a legitimate environmental, health, or safety goals such a finding shall be referred to the NAFTA dispute process for the dismissal of the complaint. Where the NACE finds that the complained of measure is not in full a legitimate environmental, health, or safety measure, the NAFTA dispute may continue, according the findings 6f the NACE great deference in making its environmental, health, safety, or conservation determinations on the application of NAFTA's provisions. This process will ensure that legitimate protections are insulated from trade challenges, without compromising the ability of the parties to address NAFTA-inconsistent protectionist trade measures.

The NACE dispute settlement procedure should also be the mechanism for NAFTA environmental, health, and safety enforcement. Disputes may be brought by NAFTA parties or the public involving environmental, health, or safety issues before the Commission. The Commission should determine which cases shall be directly referred to a NACE dispute panel. In cases where the Commission declines a matter, the Public Advisory Committee should possess authority to compel the dispute resolution under NACE. The Public Advisory Committee should also possess authority to bring complaints to NACE directly. U.S. implementing legislation should specifically acknowledge the right of U.S. citizens and groups to sue in federal court to invoke trade measures or other appropriate sanctions for violation of U.S. standards. NACE should only enforce a party's own standards.

If a dispute panel verifies a complaint by a party or individual, then that party or individual should be entitled to pursue the "snap-back" tariff provisions of NAFTA's Chapter 8 through the complainant's domestic trade agency. If a dispute

panel determines that a party or individual has suffered an environmental, conservation, health, or safety injury as a result of lax enforcement in another country, yet no trade injury exists, then NACE should possess the authority to levy a fine upon the violating entity. Mechanisms should be developed to enable monies collected through the dispute process to be used for environmental compliance.

Investigation

We believe the NACE must possess authority to investigate environmental, conservation, health, and safety matters in all NAFTA countries. The NACE should be able to commence an investigation on its own initiative or at the request of the Public Advisory Committee, the public, or a NAFTA party.

Monitoring

The Secretariat, in cooperation with the NACE Commissioners, should also possess authority to monitor the condition of the NAFTA parties' general environment. Consequently, the Secretariat should possess the authority to obtain information form the NAFTA parties' government and the general public.

NAFTA Amendments and Accession

Because of the significant impacts that either NAFTA amendments or accession would have upon the environment, the NACE Commission should make recommendations to the parties on these matters. Any new party to the NAFTA should be required to accede to the whole NAFTA package and submit a report to the NACE on its environmental, health, and safety protection schemes, as well as the enforcement of those protections. These reports could be revised by all NAFTA parties- at regular intervals thereafter.

Cooperative efforts

We further suggest the NACE promote cooperative efforts among NAFTA parties relating to trade and its environment, health, and safety implications for technology transfer, technical assistance, training, and education programs. Several successful cooperative ventures between NAFTA parties have already commenced. The potential in exporting U.S. technological expertise will not only enhance enforcement efforts in other countries, but will also generate a significant number of American jobs.

We appreciate the opportunity to brief you on these matters and look forward to working with you over the coming months and years. We hope that the protocol outlined in this letter is merely the beginning of a larger process to incorporate sound environmental oversight into the NAFTA process. Please do not hesitate to contact us if you have any questions.

Defenders of Wildlife; Center for International Environmental Law (CIEL); Friends of the Earth; Sierra Club; Public Citizen; The Humane Society of the United States; Humane Society International; Institute for Agriculture and Trade Policy; Center for Rural Affairs; National Family Farm Coalition; Earth Island institute; Marine Mammal Fund; Animal Protection Institute; Rainforest Action Network; Whale and Dolphin Conservation Society; Performing Animal Welfare Society (PAWS); The Fund for Animals; Environmeutal Investigation Agency; Environmental Solutions International; International Primate Protection League; N.Y. Public Interest Research Group, Inc.; Community Nutrition Institute; National Toxics Campaign Fund; North America Project, World Policy Institute; and Greenpeace U.S.

Senator KERRY. Thank you very much.

I think both of your testimonies are very astute and important. These are areas where everyone is feeling their way a little bit, because they are new to the debate with respect to trade; but increasingly, I think, they are critical, unavoidable, and they are going to be forced on us. And so it behooves us to really try to understand the implications, and put them front and center.

As I listened to, Mr. Spriggs, your testimony on the wage disequilibrium, and the advantages and disadvantages of companies accordingly, I am reminded that in the past I guess people have always looked at the less developed countries' starting place as part of the order of things, and assumed that there is going to be an automatic process by which people earn workers' rights, compensa-

tion, safety standards, and so forth. But it cannot be expected overnight, it is assumed.

You cannot approach this with the notion that they are going to rapidly harmonize up. Is that a fair assumption? I suppose I ask that as a devil's advocate, do we not have to really take into account the transitional processes, culturally and politically, of some of these countries, and not have an unfair set of expectations immediately?

Mr. SPRIGGS. Well, I think a lot of that was dominated by theories of what would be an appropriate development path. And a lot of people believe that, because these countries were labor-intensive countries, that they would use labor-intensive technologies, and that slowly they would build up to where they would compete with us on capital-intensive goods.

But what has happened is, as Professor Thurow was pointing out with international capital markets, they are doing that right away. So, they are already on us, in an engineering sense.

Senator KERRY. So, in other words, you have got these companies in China, or Costa Rica, or Taiwan or wherever, where they are just transplanting the exact same job that was done in Boston or in Lowell. And so, your argument is: If the skill level is sufficient, if the job product is the same, if they are sitting there doing the exact same thing the person in Lowell was doing, there is a right to expect that they ought to be living up to a higher standard with respect to the other parts of the production process.

Mr. SPRIGGS. That is right.

Senator KERRY. Production is not just making the goods, production is also the standards.

Mr. SPRIGGS. That is right. But I think, you know, you did raise a valid point before, in terms of cultural differences. I mean, a lot of what goes on in the United States is part of our culture. And so the force of American labor unions, while it has diminished, certain principles still guide the way that we think workers ought to be treated in this country.

Senator KERRY. Clearly locked doors at a Thailand plant are something you can probably make an argument about, but with respect to all of our requirements about OSHA, there is a lot of disagreement in this country, too, with respect to workman's comp, etc. Another country might turn to you and say, "Hey look, if you guys want to pay that amount of money to your people, that is your choice. But we just do not want to, and we are not going to." Then what?

Mr. SPRIGGS. Well, I think we have to look at workers' rights within the context of what are the workers able to bargain for themselves? And I think that is really the issue that makes the issue different from just the specifics.

Senator KERRY. Well, again, they do not have a union.

Mr. SPRIGGS. That is right.

Senator KERRY. So, not having a union, which was a hard fought matter in this country also, they may say to you, "We do not want to have that either." And we have got a lot of people in this country who say something. Only 11 percent of our workforce is unionized today. And the reason that people are choosing in many companies not to unionize is that the corporate ethic has really changed suffi-

ciently so that employers provide those benefits anyway, or they do not think they will have a workforce. Is that correct?

Mr. SPRIGGS. That is right, to an extent that is right. I mean, that is part of what keeps American unionization low. I think that we also have some problems with our own labor code and our own workers' rights, as well.

But the issue is, what do you do if a country says to you that you have these standards because you are the United States, and we do not want your standards, or we do not agree with your political system? I think we should have the same type of response that we have to have with any other type of subsidy; that if the subsidy is in the form of workers not being able to get wages that reflect their productivity, so that the unit labor costs of operating in that country are lower, so that their companies are given a competitive advantage, whether that subsidy comes from low wages, or whether the Government says, look, we will just give companies $50,000, I mean, it is a subsidy. So, I think our response has to be the same.

Senator KERRY. Is it really? I mean, was it a subsidy when folks down in South Carolina, North Carolina, et cetera, worked at a lower wage than people in Lowell and Lawrence, and our mills went south?

Mr. SPRIGGS. Well, there you are right, we had different wage levels, but we did play by the same set of rules, in terms of having a national wage. There is no way that you could get someone today to work for less than $4.25, because we had the Federal minimum wage to cover interstate commerce activity. So, at least there are some floors to which we agree. Now, those floors may be so low that they create big gaps within our own country, and that is true, and that has created the type of movement that you are mentioning.

Senator KERRY. But you cannot take a country whose economy is at a certain level, and suddenly disequilibrate it to the point that they are going to pay a wage that the economy does not bear. I mean, there is no market force in that; there is no market sustainability, either.

Mr. SPRIGGS. Well, no. That is the point. The wages of these workers does not reflect low productivity. A certain portion of their wage does reflect this huge pool of workers who are available for work, but cannot get into the modern sector because it is not big enough. But another portion of their wage, their low wage, is reflective of their inability to get wages closer to their productivity increases. So that Mexican workers, who are in a factory run by an American company, who make engines as productively as their American counterpart, cannot organize in a way to bid that wage up anywhere close to the U.S. wage level.

Senator KERRY. How do you think you integrate these kinds of differentials into GATT policy, without infringing on sovereignty, and so forth?

Mr. SPRIGGS. Well, I think as we see the way in which trade actually gets conducted, we see there are very few things which really are or can be left as domestic issues. Because it is the whole environment that sets up some of these comparative advantages that countries are able to create. So, I think that we have to step away from thinking of workers' rights as being some sovereign issue.

Now, at some point, of course, this does cross over, because you start talking about human rights; and there is a thin between what is a human right and what is a worker's right. And I would agree that that is a difficult line to draw. If you do not have the right of freedom of speech, it is very hard to argue that a union could ever function. And if there is not a recognized sense of freedom of speech, then saying that the country has the right to organize would be pointless.

Senator KERRY. Some would argue, as they have—and this is why I asked you about why the Bush administration stayed away from it—that this is such a slippery slide, that once you get on it, you just cannot get anywhere, you cannot find definitions. Would you agree with that?

Mr. SPRIGGS. No, I would not agree with that. I mean, there are many countries who have already signed onto more of the ILO conventions than the United States. Many of them are these same less developed nations.

Senator KERRY. Are they enforcing them?

Mr. SPRIGGS. No, they are not enforcing them. That is where we have to take things to the next level, which is to get them to enforce what it is that they at least say they agree to. However, I think we have a framework from which we can begin the dialog. And that is that people do seem to basically agree with what are acceptable worker rights. We have to use that framework to start the hard part, and that is, how do you get people to agree to enforce them in a meaningful way?

But if we leave that to chance, then I think what we leave to our own workers, is this continued type of pressure that, well, we cannot have that in our American labor code because it will make American companies less competitive. We faced this with the Family Medical Leave Act, even though other industrialized nations have paid leave—even Mexico has paid leave—and we are going to face that with the striker's rights bill.

Senator KERRY. Let me ask you, Mr. Housman, on the same line, with regard to the NAFTA side agreements, people say, defeat the concept of having a free trade agreement; and that you are basically also beginning to tread on sovereignty issues. What is your response to that?

Mr. HOUSMAN. I think that line of analysis—which runs along the lines of first we are much better off with a NAFTA than without a NAFTA; and then, second, do not let NAFTA collapse under its own weight—totally misses the point.

The point lies in ensuring that this agreement meets the standards that we set out for it. I do not think the standard we set for the NAFTA should be a baseline standard of is this agreement better than no agreement. The standard should be: Does this agreement achieves our goals?

I harken back to my days in college and in law school. I never was happy with a C. I always at least sought after an A. I may not have always achieved it, but I at least sought after an A. To say that we are willing to accept a C agreement, because that is the best we can do, is shortsighted.

Senator KERRY. What do you say, from a philosophical approach, to the sovereignty issue in terms of both legal and political terms?

Mr. HOUSMAN. As to sovereignty, I think sovereignty is an interesting concept right now. It has become what "national security" was, during the 1970's and 1980's. It is a catch phrase for the status quo. Whenever you want to justify inaction, you say "national sovereignty." Anybody who wants to read through the NAFTA itself—and it is a wonderful, wonderful sedative—anybody who wants to read through the agreement itself can see countless areas where the agreement treads freely upon sovereignty.

The IPR section, which was just discussed a moment ago by Mr. Spriggs, is all about getting Mexico to recast its entire judicial system in the IPR area. If that is not an intrusion upon sovereignty, I do not know what is.

We give up sovereignty in trade agreements because we think there are other benefits. Now, some people want to limit those benefits to solely trickle-down economic benefits, and that is precisely what President Clinton, during the campaign, campaigned against; against trickle-down economics, and a failed system.

I think the value of this hearing is to help us move away from that narrow mindset, to think about how we can expand our notion of economic policy. And so, sovereignty is a wonderful concept, but this concept is changing and evolving as well.

Senator KERRY. That raises the issue, obviously, of the reverse of what happens to us under these agreements. Under the GATT agreement on the tuna/dolphin steps that we took, that I had sponsored in this committee, we tried to take action to protect something that we saw as a major environmental issue. And under article 20 of GATT, I personally believe it is permissible to protect and conserve human life and other life. GATT, obviously, in its preliminary panel, has ruled against us; and the implications are foreboding.

What about, generally speaking, the fears that a lot of environmental groups and others have, with respect to the possibility that some of these agreements will drag our standards down? Is that a real threat? And do you see that in both agreements?

Mr HOUSMAN. If you look at what is occurring, I think it definitely is a real threat. I am not a doomsday advocate, though.

Senator KERRY. Well, here is an example: If GATT finally ruled against us on this, we then have to change our law with respect to protection of tuna, of the dolphin.

Mr. HOUSMAN. Or suffer trade retaliation. Exactly. It is not just big, wonderful sea mammals that are at stake here. The next challenge is to our CAFE standards, Corporate Average Fuel Economy Standards. After that, it may be export restrictions in the Pacific Northwest that are threatened. After that, it might be the administration's energy tax proposal.

These trade rules serve much like the tax code, they affect all sorts of behavior. It is important to recognize that fact. And, as you said, there is a threat that, if improperly conceived, these rules can serve to drag us down along with the rest of the world. I think that there are several things that can be done about it. One of the things is to look at the standards section of the Uruguay Round, and make a real go at correcting them. Otherwise, they will lock in precisely the type of bad jurisprudence that you have already

discussed today, and that you have already spoken eloquently on in the past about the need to redress.

Senator KERRY. Well, gentlemen, unfortunately the clock is running on us, and I have got to go over to this conference. And we are only scratching the surface on this, which is all we will do in this effort, at least initially.

But we are going to continue to do this. I think the chairman's presence here today is indicative of the fact that the committee as a whole, and the subcommittee, intend to really try to raise this issue to a higher level of scrutiny now; all of the issues that we have discussed today.

You cannot talk about the job loss in this country, or the other priorities that we have, among them the environment, et cetera, without confronting these issues. And frankly, we have avoided a confrontation with these issues in a wholesale, frightening way these past years, notwithstanding prior warnings.

This committee's hearing today is not, and does not pretend to be, the first heralding of these warnings. On the other hand, what we are trying to do is say this: We are going to be a lot more aggressive about trying to put this agenda on the table and begin to understand it.

It is very, very clear to me that we are heading down a crisis road, the proportions of which we really have not yet defined, and maybe do not understand. If we do not begin to grapple with some of these issues, we are going to have a political cauldron burning around us in this country, for the unemployed, and the underemployed, and the others who are saying, "What the hell happened?"

And, unless we begin to take arms against the practices of these other countries, who are voracious in their appetite and clear in their strategy, I just see worse things down the road. As Lester Thurow said, every $45 billion of that trade deficit is 1 million jobs of Americans, that have gone overseas. And for those that are watching closely, there is not a lot replacing it today.

Therefore, we had better really think hard about this trade structure within which we are operating. And I do not think it is sufficient merely to quote Adam Smith with high hopes that people are going to live by those standards, when we know very well over the last years they simply are not. It is that simple.

Now there are new ingredients, and for that reason we wanted to have this panel, and you have well articulated them; and your written testimonies are very articulate statements of these imperatives. If we are going to talk about sustainable development, if we are going to deal with deforestation of the Amazon, our own virgin forests, Thailand, Philippines, Guatemala, Central America, and a host of other forests that are disappearing, we clearly need to be talking about alternatives and other methods of dealing with these issues.

Now, I am not going to pretend to you that the market is not going to deal with that somehow, at some point. It is. When you do not have any trees, something else will take its place. But the problem is that the implications for flooding, for disease transmittal, for CO_2 and global warming, with the loss of those trees, is simply unacceptable. And, unless we arrive at some ingredient

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within our trade regimen that talks about these things, we are not beginning to grapple with the problem.

So, I thank you for helping this committee to dig into this a little bit, and we will continue this process as the days and months go on. And I thank you very much for being here.

We stand adjourned.

[Whereupon, at 1:25 p.m., the hearing was adjourned.]

APPENDIX

Prepared Statement of Senator Pressler

Mr. Chairman, I want to thank you for holding this hearing on U.S. competitiveness in the global marketplace. Being competitive in world markets is key to the future economic growth of the United States.

No longer is world supremacy based on military strength. Instead, super-power status will be determined on the economic playing field. This is symbolized in current U.S.-Japan trade disputes. it also is exemplified in U.S. efforts to reduce the abusive use of export subsidies by the European Community, which literally has robbed the United States of many of its historic markets.

Flexing regional economic muscle is evident in the drive to create world trading blocs—the most obvious being the EC, the U.S.-Canada Free Trade Agreement, and the proposed North American Free Trade Agreement (NAFTA). The United States must remain competitive if we are to succeed in the world marketplace.

As the world enters the 21st century, the future economic growth of the world's developing countries and lesser-developed countries will largely be determined during the current negotiations for a new General Agreement on Tariffs and Trade (GATT). What concessions are afforded those countries will determine their opportunities of becoming fully developed and economically independent.

Many decisions will be made this year by Congress that will determine how well the United States will fare in the world marketplace of the 21st century. Most notably Most-Favored-Nation status for China, NAFTA, a new GATT, and trade opportunities in the former Soviet Union.

The stakes are tremendous. Every billion dollars worth of manufactured exports means 20,000 U.S. jobs. Every billion dollars worth of U.S. agricultural exports sustain 26,000 American jobs.

What steps or actions are needed to enhance the demand for U.S. products? How best can the United States counter being placed at a competitive disadvantage when foreign governments promote specific industries, whether it is agriculture or the European aircraft consortium Airbus Industrie?

I look forward to hearing the testimony that is being presented today. Hopefully, many questions can be answered by their presentations.

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